

# Other Exam CIA

Certified Internal Auditor

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**QUESTION: 1**

Which of the following audit findings would have the least impact (either positive or negative) on a department's control environment?

- A. The department makes long-term investment risk decisions to maximize return on investment.
- B. The department manager sets and demonstrates a tone of honesty and integrity in all business dealings.
- C. any department functions are duplicated or verified by other department employees.
- D. Deficiencies were found in the appropriate authorization of transactions.

**Answer: A**

**QUESTION: 2**

According to the Standards, which of the following best describes the concept of due professional care?

- A. Internal auditors must apply the diligence and skill expected of a reasonably prudent and competent internal auditor.
- B. Internal auditors must possess the knowledge, skills, and other competencies needed to perform their audit responsibilities.
- C. Internal auditors must have sufficient knowledge to identify fraud.
- D. Internal auditors must refrain from participating in an engagement when they lack sufficient knowledge, skills, and competencies to assess the audit area fully.

**Answer: A**

**QUESTION: 3**

Which of the following is not true with regard to the internal audit charter?

- A. It defines the authorities and responsibilities of the internal audit activity.
- B. It specifies the minimum resources needed for the internal audit activity.
- C. It provides a basis for evaluating the internal audit activity.
- D. It should be approved by senior management and the board.

**Answer: B**

**QUESTION: 4**

In assessing the independence of the internal audit activity, a member of a peer review team should consider all of the following factors except

- A. Access to and frequency of communications with the board of directors or its audit committee.
- B. The criteria of education and experience considered necessary when filling vacant positions on the audit staff.
- C. The degree to which auditors assume operating responsibilities.
- D. The scope and depth of engagement objectives for the audit engagements included in the review.

**Answer: B**

**QUESTION: 5**

To enhance the independence of both the internal and external audit functions, audit committees should be composed of

- A. A rotating subcommittee of the board of directors or its equivalent.
- B. A combination of external members of the board of directors and company officers.
- C. Members from all important constituencies, specifically including representatives from banking, labor, regulatory agencies, shareholders, and officers.
- D. Only external members of the board of directors or other similar oversight committees.

**Answer: D**

**QUESTION: 6**

According to the Standards, the organizational status of the internal audit activity

- A. Must be sufficient to permit the accomplishment of its audit responsibilities.
- B. Is best when the reporting relationship is direct to the board of directors.
- C. Requires the board's annual approval of the audit schedules, plans, and budgets.
- D. Is guaranteed when the charter specifically defines its independence.

**Answer: A**

**QUESTION: 7**

An employee who recently transferred into the internal audit activity has been assigned to audit the accounts payable system. Which function, if previously performed by the auditor, would represent a conflict of interest?

- A. Monitoring the allowance for doubtful accounts.
- B. Writing procedures for the handling of duplicate payments.

- C. Signing timekeeping cards for subordinates.
- D. Reviewing shipping documents for accuracy.

**Answer: B**

**QUESTION: 8**

Two individuals are being considered for an audit team that is to perform a highly technical review. Which of the following situations would preclude selection of the individual for the audit due to an objectivity concern?

- I. Person A is a member of the internal audit staff and has the required technical skills. Person A participated in a controls review of the system to be audited when it was being developed.
- II. Person B is a technical specialist who understands the audit area but is not a member of the internal audit staff. Although person B has personal credibility in the information systems department to be audited, person B works for another department in the organization.

- A. I only.
- B. II only.
- C. Both I and II.
- D. Neither I nor II.

**Answer: D**

**QUESTION: 9**

Management asked the internal audit activity to evaluate the appropriateness of self-insuring against casualty losses and health care for the organization's employees. Should the chief audit executive engage an actuarial consultant to assist in the audit engagement if these skills do not exist on staff?

- A. No, because the internal audit activity is skilled in assessing controls and the insurance control concepts are not distinctly different from other control concepts.
- B. No, because it is a normal audit function to assess risk; this audit engagement is therefore not unique.
- C. Yes, because an actuarial consultant is essential to determine whether the health-care costs are reasonable.
- D. Yes, because an actuarial consultant has skills, not usually found in the internal audit activity, to identify and quantify self-insurance risks.

**Answer: D**

**QUESTION: 10**

Which of the following would be the best source of information for a chief audit executive to use in planning future audit staff requirements?

- A. Discussions of audit needs with executive management and the audit committee.
- B. Review of audit staff education and training records.
- C. Review of audit staff size and composition of similar-sized companies in the same industry.
- D. Interviews with existing audit staff.

**Answer: A**

**QUESTION: 11**

Which of the following steps would not be included in a program of selecting and developing human resources for an internal audit department?

- A. Scheduling periodic meetings with individual auditors, during which the chief audit executive provides counsel regarding each auditor's performance and professional career development.
- B. Establishing an internal review team to assess the auditors' and audit department's compliance with standards, level of audit effectiveness, and compliance with departmental policy.
- C. Developing specific job descriptions for audit staff, audit managers, and other auditing positions.
- D. Establishing in-house training programs and requiring continuing education for audit staff.

**Answer: B**

**QUESTION: 12**

To ensure that due professional care has been taken during an audit engagement, an internal auditor should always

- A. Ensure that all financial information related to the engagement is included in the audit plan and examined for irregularities.
- B. Document all audit tests completely.
- C. Consider the possibility of noncompliance or irregularities at all times during an engagement.
- D. Notify the audit committee of any noncompliance or irregularity discovered during an engagement.

**Answer: C**

**QUESTION: 13**

According to the Standards, which of the following must an internal auditor take into consideration when performing an assurance engagement of treasury operations?

- I. The audit committee has requested assurance of the treasury department's compliance with a new policy on the use of financial instruments.
- II. Treasury management has not instituted any risk management policies.
- III. Due to the recent sale of a division, the amount of cash and marketable securities managed by the treasury department has increased by 350 percent.
- IV. The external auditors have indicated some difficulties in obtaining account confirmations.

- A. I and II only
- B. I and IV only
- C. I, II, and III only
- D. II, III, and IV only

**Answer: C**

**QUESTION: 14**

To promote a positive image within an organization, a chief audit executive (CAE) adjusted the audit plan to focus on assurance engagements that highlighted potential costs to be saved. Negative observations were to be omitted from engagement final communications. Which action taken by the CAE would be considered a violation of the Standards?

- I. The focus of the audit function was changed without modifying the audit charter or notifying the audit committee.
- II. Negative observations were omitted from the engagement final communications.
- III. Cost savings and recommendations were highlighted in the engagement final communications.

- A. II only
- B. I and II only
- C. I and III only
- D. I, II, and III

**Answer: B**

**QUESTION: 15**

In selecting an instructional strategy for developing internal audit staff, a chief audit executive should first review the

- A. Department's budget constraints
- B. Internal auditors' personal development needs
- C. Content of potential training courses
- D. Organization's objectives.

**Answer:** D

**QUESTION:** 16

Continuing Professional Education (CPE) hours for Certified Internal Auditors may be achieved by

- A. Attending audit staff meetings
- B. Verifying that all completed audit tests are fully documented.
- C. Publishing an article on the company's internal audit department.
- D. Obtaining experience on the job.

**Answer:** C

**QUESTION:** 17

Which of the following activities is designed to provide feedback on the effectiveness of an internal audit function?

- I. Proper supervision.
- II. Proper training.
- III. Internal assessments
- IV. External assessments

- A. I, II, and III only
- B. I, II, and IV only
- C. I, III, and IV only
- D. II, III, and IV only

**Answer:** C

**QUESTION:** 18

An internal quality assessment of the internal audit activity should provide the chief audit executive with

- A. Recommendations for improvement
- B. Objectives for internal audit engagements

- C. Confirmation of action on past audit recommendations
- D. Appraisals of internal audit staff performance

**Answer:** A

**QUESTION: 19**

In publicly held companies, management often requires the internal audit activity's involvement with quarterly financial statements that are made public and used internally. Which of the following is generally not a reason for such involvement?

- A. Management may be concerned about its reputation in the financial markets.
- B. Management may be concerned about potential penalties that could occur if quarterly financial statements are misstated.
- C. The Standards state that internal auditors should be involved with reviewing quarterly financial statements.
- D. Management may perceive that having quarterly financial information examined by the internal auditors enhances its value for internal decision making.

**Answer:** C

**QUESTION: 20**

Risk assessments can vary in format, but generally include

- I. A description of identified risks.
- II. Tests of audit controls
- III. A system of rating risks
- IV. Sample size identification

- A. I and II only
- B. I and III only
- C. I, III, and IV only
- D. II, III, and IV only

**Answer:** B

**QUESTION: 21**

An organization receives the most value from an internal audit activity's enterprise-wide risk assessment when the auditor

- A. Focuses primarily on enterprise-level risks
- B. Considers activities at all levels of the organization



- C. Reviews special projects and new initiatives
- D. Validates supporting financial and operational data

**Answer:** B

**QUESTION: 22**

Internal auditors who are concerned with potential risks due to the mishandling of records or transactions should take into consideration

- A. The type and nature of the activities to be examined
- B. Whether employees in key positions of trust are bonded
- C. The history of losses suffered by the company
- D. The results of prior risk assessments

**Answer:** A

**QUESTION: 23**

A chief audit executive (CAE) used an electronic spreadsheet to facilitate the risk assessment process for a number of different divisions. The spreadsheet included the following factors Complexity of operations Competence of divisional personnel Dollar amount of accounts where management's judgment can affect the expense. The CAE used a group meeting of audit managers to reach a consensus on the competence of divisional personnel. Other factors were assessed as high, medium, or low risk by either the CAE or an audit manager who had audited the division. The CAE weighted each factor and computed a composite risk score. Which of the following statements is correct regarding this risk assessment process?

- A. The risk analysis would not be appropriate because it mixes both quantitative and qualitative factors.
- B. Assessing factors at discrete levels, such as high, medium, and low, is inappropriate for the risk assessment process because the ratings are not quantifiable.
- C. The weighting is subjective and should have been determined through a process such as multiple regression analysis.
- D. Using a subjective group consensus to assess personnel competence is appropriate.

**Answer:** D

**QUESTION: 24**

Which of the following is a risk factor that a chief audit executive should consider when prioritizing audit work schedules?

- I. Quality of internal control
- II. Management competence

- III. Time of last audit engagement
- IV. Degree of change or organizational stability

- A. I and III only
- B. I, II, and IV only
- C. II, III, and IV only
- D. I, II, III, and IV

**Answer:** D

**QUESTION: 25**

A company has entered into a \$20,000,000 fixed-price contract with a general contractor for the construction of a new retail outlet. For this contract, which of the following would represent the greatest risk?

- A. Excessive labor charged to the project
- B. Poor physical protection of materials and equipment
- C. Failure to complete the project within budget
- D. Substitution of inferior materials

**Answer:** D

**QUESTION: 26**

The chief audit executive for an organization has just completed a risk assessment process, identified the areas with the highest risk, and assigned an audit priority to each. Which of the following statements is true and consistent with the International Professional Practices Framework?

- I. Items should be ranked in the order of quantifiable dollar exposure to the organization.
- II. The audit priorities should be in order of major control deficiencies.
- III. The risk assessment, though quantified, is the result of professional judgments about both exposures and probability of occurrences.

- A. I only
- B. III only
- C. II and III only
- D. I, II, and III

**Answer:** B

**QUESTION: 27**

All of the following would normally be involved in preparing for and carrying out the internal audit activity's annual plan except

- A. Establishing policies and procedures for workpapers and referencing
- B. Providing periodic activity reports to the audit committee on audit engagements in progress
- C. Assessing the amount of risk in major departments
- D. Training audit staff on appropriate audit methodologies for addressing any newly identified risks.

**Answer:** A

**QUESTION: 28**

Responsibility for the coordination of internal audit and external audit efforts should be documented in the

- A. Engagement work schedule
- B. Internal audit charter
- C. Internal assessment report
- D. Internal audit activity's strategic plan

**Answer:** B

**QUESTION: 29**

Internal auditors can benefit from a strong relationship with the external auditors because external auditors can

- A. Provide internal auditors with an independent and knowledgeable viewpoint
- B. Concur with the internal auditors' reports and thus improve the quality of assurance provided to management
- C. Increase the effectiveness of internal control sampling techniques
- D. Assist the internal auditor by providing information obtained from similar audits with other clients

**Answer:** A

**QUESTION: 30**

Coordinating internal and external audit efforts can help reduce the amount of time that the external auditors are on site at an organization because the external auditors can

- A. Copy audit findings from internal audit reports to create the external audit report
- B. Rely on work performed by the internal audit activity
- C. Use risk and control analysis provided by the internal audit activity to guide testing for the external audit staff
- D. Focus on high-risk areas only, as long as an internal audit function exists

**Answer:** B

**QUESTION: 31**

Using the internal audit department to coordinate regulatory examiners' efforts is beneficial to the organization because internal auditors can

- A. Influence regulatory interpretation of law to better match corporate practice
- B. Recommend changes to the scope of the regulatory examiners' review
- C. Perform fieldwork for the regulatory examiners and thus shorten the regulatory examiners' review
- D. Supply evidence of adequate compliance testing through internal audit workpapers and reports

**Answer:** D

**QUESTION: 32**

If the annual audit plan does not allow for adequate review of compliance with all material regulations affecting the company, the internal audit activity should

- A. Ensure that the regulations that were not included be reviewed in the subsequent year
- B. Include a memo in the audit planning file listing the reasons for the lack of coverage.
- C. Notify the board of directors and senior management of the limitation
- D. Decrease the scope of operational and financial audits to make additional audit time available

**Answer:** C

**QUESTION: 33**

Which of the following statements, if true, could justify an auditor's decision not to report governance-related control deficiencies to the audit committee?

- A. Management plans to initiate corrective action
- B. The board of directors has a separate corporate governance committee
- C. The amounts and the potential risks associated with the deficiencies are not material to the overall organization.
- D. Governance issues are complex and the auditor should rely on management's analysis of the extent of the problem

**Answer:** C

**QUESTION:** 34

The primary purpose for the chief audit executive's communication of the internal audit activity's plans and resource requirements to senior management and the board is to

- A. Identify internal audit engagement scope limitations
- B. Indicate future internal audit staffing needs
- C. Highlight the internal audit activity's view of significant risk areas
- D. Ensure that the work of the internal audit activity supports the organization's objectives

**Answer:** D

**QUESTION:** 35

In a well-developed management environment, the internal audit activity would

- A. Report the results of audit engagements to line management as well as to senior management
- B. Conduct regularly scheduled audits of existing systems and initial audits of new computer systems after they have begun operating.
- C. Interface primarily with senior management, minimizing interactions with line managers who are the subjects of internal audit work.
- D. Focus on the maintenance of accounting controls (such as segregation of the duties of authorization, recording, and custody) and report results to the audit committee

**Answer:** A

**QUESTION:** 36

According to the International Professional Practices Framework, which of the following describes a key objective of the risk management process that would also be a key responsibility of the internal audit activity?

- A. Determine the level of risk acceptable to the organization, including the acceptance of risks designed to accomplish the organization's strategic plans.
- B. Design and implement risk mitigation activities to reduce risk to levels that have been determined to be acceptable.
- C. Receive periodic reports of the results of the risk management processes.
- D. Conduct ongoing monitoring activities to periodically reassess risk and the effectiveness of the controls to manage risk.

**Answer: D**

**QUESTION: 37**

Which of the following represents the most effective governance structure?

	Operating Executive	Internal Management	Management Auditing
I.	Responsibility for risk	Oversight role	Advisory role
II.	Oversight role	Responsibility for risk	Advisory role
III.	Responsibility for risk	Advisory role	Oversight role
IV.	Oversight role	Advisory role	Responsibility for risk

- A. I.
- B. II.
- C. III.
- D. IV.

**Answer: A**

**QUESTION: 38**

The internal audit activity's role in the risk assessment and management processes of an organization is determined by the

- A. Board of directors
- B. Chief audit executive
- C. Risk management department
- D. External auditors

**Answer: A**

**QUESTION: 39**

An organization's chief audit executive (CAE) has been asked to monitor and report on any violations of the organization's code of conduct. The CAE should

- A. Review and adjudicate all complaints
- B. Lead the committee responsible for the oversight of the code
- C. Develop specific procedures to ensure that the code is clearly communicated to all employees
- D. Participate in an advisory capacity on the committee that adjudicates any violations

**Answer: D**

**QUESTION: 40**

The primary objective of risk-based auditing is to assess the

- A. Economy of controls
- B. Compliance with controls
- C. Adequacy of controls
- D. Efficiency of controls

**Answer: C**

**QUESTION: 41**

Which of the following would be most relevant regarding the internal control environment?

- A. Assessing controls over computerized applications
- B. Documenting the organizational structure
- C. Comparing and validating internal performance with external benchmarking
- D. Maintaining and reviewing detailed financial records

**Answer: B**

**QUESTION: 42**

Which of the following would provide the best assessment of an organization's ethical climate?

- A. Number of years that directors have been appointed to the board
- B. Evidence of training provided to the board of directors on ethical issues.
- C. Clarity and consistency of consequences imposed by the board of directors for ethical violations
- D. Frequency of fraud reported and results of subsequent investigations

**Answer: C**

**QUESTION: 43**

When reviewing management reports to the board of directors, the internal audit activity should

- A. Evaluate the process used to prepare the management reports.

- B. Maintain supporting documentation for the management reports.
- C. Tie all financial numbers in the reports to the general ledger
- D. Compare to prior-period reports for consistency.

**Answer:** A

**QUESTION:** 44

What role, if any, should the internal audit activity have in the process of following up on observations and recommendations made by the external auditors?

- A. The internal audit activity should have no role in this process in order to ensure independence.
- B. The internal audit activity should become involved only if the chief audit executive has sufficient evidence that the follow-up is not occurring.
- C. The internal audit activity should review the adequacy and effectiveness of management's follow-up actions.
- D. The internal audit activity should become involved only if specifically requested by management or the board of directors.

**Answer:** C

**QUESTION:** 45

Which of the following elements should an auditor recommend for inclusion in an organization's code of ethics?

- I. Ethics should vary with local customs in the organization's foreign operations.
- II. Whistle-blowing should be discouraged because it can cause distrust among employees and false accusations which waste organizational resources on investigations.
- III. Ethical behavior should not be incorporated into performance evaluations because it is too subjective and controversial.

- A. I only
- B. II only
- C. I, II, and III
- D. None of the above

**Answer:** D

**QUESTION:** 46

A tax consultancy agency retains sensitive personal information regarding its clients. Which of the following is a violation of acceptable privacy practices?



- A. Copies of printed client information not used by the agency are shredded
- B. Employees share client information with coworkers with the permission of the client
- C. The agency only releases client information with management's approval
- D. The agency advises clients of their privacy rights before they commence business with the agency

**Answer:** C

**QUESTION:** 47

Noncompliance with which of the following would cause a control deficiency related to privacy protection practices?

- I. An organization's internal privacy policies
- II. Financial accounting standards
- III. Privacy laws and regulations
- IV. The Standards

- A. I and III only
- B. II and IV only
- C. II, III, and IV only
- D. I, II, III, and IV

**Answer:** A

**QUESTION:** 48

During a review of data center physical security and environmental controls, an auditor should ensure that

- I. Visitors are accompanied by authorized personnel at all times
- II. Only developers and operators have access to the data center
- III. Fire suppression equipment is tested periodically
- IV. Fire and water detectors have been installed

- A. I and III only
- B. II and IV only
- C. I, III, and IV only
- D. II, III, and IV only

**Answer:** C

**QUESTION:** 49

Which of the following is most likely to be an element of an effective compliance program?

- A. The internal audit activity is assigned responsibility for overseeing the program.
- B. The program is communicated to employees in a video format on a one-time basis.
- C. The organization uses monitoring systems designed to detect improper activity.
- D. The organization obtains as much information as possible when performing background checks on employees.

**Answer: C**

**QUESTION: 50**

Which of the following statements is correct regarding corporate compensation systems and related bonuses?

- I. A bonus system should be considered part of the control environment of an organization and should be considered in formulating a report on internal control.
- II. Compensation systems are not part of an organization's control system and should not be reported as such
- III. An audit of an organization's compensation system should be performed independently of an audit of the control system over other functions that impact corporate bonuses.

- A. I only
- B. II only
- C. III only
- D. II and III only

**Answer: A**

**QUESTION: 51**

Which statement most accurately describes risk assessment?

- A. It is a tool for determining the relative impact of one process on another.
- B. It is a model used by analysts to determine organizational exposure.
- C. It is the quantitative and qualitative evaluation of exposures.
- D. It is the amount of inherent risk in a separately identifiable business entity or transaction.

**Answer: C**

**QUESTION: 52**

Risk within an internal audit engagement is defined as the

- A. Probability that a balance or class of transactions and related assertions contain misstatements that could be material to the financial statements.

- B. Uncertainty of an event occurring that could have an impact on the achievement of objectives.
- C. Failure to adhere to organizational policies, plans, and procedures, or the failure to comply with relevant laws and regulations.
- D. Failure to accomplish established objectives and goals for operations or programs.

**Answer:** B

**QUESTION:** 53

Which of the following is a common element of any risk framework?

- A. Organizational objectives
- B. Anticipated product losses
- C. Board of directors' policies
- D. Delegation of authority

**Answer:** A

**QUESTION:** 54

What is residual risk?

- A. Impact of risk
- B. Risk that is under control
- C. Risk that is not managed
- D. Underlying risk in the environment

**Answer:** C

**QUESTION:** 55

All of the following statements regarding the responsibility for risk management in an organization are true except

- A. Risk management is ultimately the responsibility of the board
- B. Risk management is enhanced through periodic assessment by line management
- C. Risk management includes the acceptance of residual risk by executive management
- D. Risk management requires the involvement of the internal audit activity in order to be accepted by the board

**Answer:** D

**QUESTION: 56**

What is risk management?

- A. Identifying and prioritizing risks
- B. Measuring risks and determining consequences
- C. Identifying threats to the organization and likelihood of occurrence
- D. Determining how much risk is acceptable and what action should be taken.

**Answer: D**

**QUESTION: 57**

The primary reason that a bank would maintain a separate compliance function is to

- A. Better manage perceived high risks
- B. Strengthen controls over the bank's investments
- C. Ensure the independence of line and senior management
- D. Better respond to shareholder expectations

**Answer: A**

**QUESTION: 58**

When reviewing operational risk for a department whose manager adopts a laissez-faire style of leadership, it is most important for the internal auditor to verify that

- A. Employee decisions follow department and company guidelines
- B. The manager considers employees' input when designing new procedures
- C. Employees are empowered to deal with unusual or emergency situations
- D. Management has adopted an open-door policy to assist with communication

**Answer: A**

**QUESTION: 59**

A major corporation is considering significant organizational changes. Which of the following groups would not be responsible for implementing these changes?

- A. Employees
- B. Senior management
- C. Common stockholders

D. Outside consultants

**Answer: C**

**QUESTION: 60**

In order to effectively handle conflict between audit team members, an audit team leader should

- A. Avoid addressing the conflict until the leader is sure that there is a problem.
- B. Be assertive and keep the team members focused on a resolution.
- C. Ask one of the team members to resolve the issue by being more conciliatory.
- D. Transfer one of the team members to another assignment.

**Answer: B**

**QUESTION: 61**

Which of the following would be the best example of a monitoring control for a chain of restaurants?

- A. Each restaurant manager reconciles the cash received with the food orders recorded on the computer
- B. All food orders must be entered through the computer, and there is segregation of duties between the food servers and the cooks.
- C. Corporate management prepares a detailed analysis of gross margin per restaurant and investigates those showing a significantly lower gross margin.
- D. Proof of bank deposit is transmitted to corporate headquarters on a daily basis.

**Answer: C**

**QUESTION: 62**

What is the most effective and efficient control to prevent the diversion of office supplies to an employee's residence by entering an alternate delivery location in an electronic data interchange system?

- A. Compare the total number of items ordered with the total number of items received at all mail rooms, and investigate shortages.
- B. Generate a periodic report that lists any orders with delivery destinations other than company mail rooms, and trace to shipping documents.
- C. Allow only valid mail room location fields to be used, and require changes to the table of valid locations to be approved on-line.
- D. Instruct the vendor to deliver only to the mail room for the largest location, and have company personnel send supplies to other locations as needed.

**Answer: C**

**QUESTION: 63**

Which of the following is an example of a corrective control?

- A. Bank accounts are reconciled monthly.
- B. Exception reports are investigated and resolved.
- C. Employees are directed to obtain additional training each year.
- D. Invoices are reconciled to receiving reports before payments are authorized.

**Answer: B**

**QUESTION: 64**

All of the following would be part of a control system to prevent release of waste water that does not meet discharge standards except

- A. Performing chemical analysis of the water, prior to discharge, for components specified in the permit.
- B. Specifying (by policy, training, and advisory signs) which substances may be disposed of via sinks and floor drains within the facility.
- C. Periodically flushing sinks and floor drains with a large volume of clean water to ensure that pollutants are sufficiently diluted.
- D. Establishing a preventive maintenance program for the pretreatment system.

**Answer: C**

**QUESTION: 65**

An organization's sales professionals are potentially abusing the use of cellular phones, resulting in an alarming increase in telephone expenses. Which of the following controls is least likely to curb this abuse?

- A. Developing periodic reports to management that show type, length, and number of calls per sales professional, with related totals and comparisons.
- B. Requiring sales professionals to pay monthly cellular phone bills and subsequently submit only business calls for reimbursement using an expense report process.
- C. Requiring sales managers to approve monthly bills prior to payment, explain budget variances, and explain increases from previous periods.
- D. Requiring authorization of the cellular phone bill payment by the manager of the telecommunications department.

**Answer: D**

**QUESTION: 66**

In advance of a preliminary survey, a chief audit executive sends a memorandum and questionnaire to the supervisors of the department to be audited. What is the most likely result of that procedure?

- A. It creates apprehension about the audit engagement.
- B. It involves the engagement client's supervisory personnel in the audit.
- C. It is an uneconomical approach to obtaining information.
- D. It is only useful for audits of distant locations.

**Answer: B**

**QUESTION: 67**

During the planning phase of an audit of suspected overbilling on contracts for security services, an auditor should perform all of the following except

- A. Interviewing an official of the security services company to determine the cause of recent increases in billings for services.
- B. Interviewing the manager who requested the audit engagement.
- C. Obtaining a copy of the contract between the two organizations.
- D. Preparing an engagement program.

**Answer: A**

**QUESTION: 68**

When performing benchmarking during the planning phase of a performance audit, an internal auditor should

- A. Determine the current performance gap.
- B. Project future performance levels.
- C. Develop functional action plans.
- D. Identify comparative organizations.

**Answer: D**

**QUESTION: 69**

Which of the following reasons best justifies the time spent coordinating the work of the internal and external auditors?

- I. Coordination improves overall audit coverage.
- II. Coordination assures the quality of internal audit work.
- III. Coordination encourages compliance with the Standards.
- IV. Coordination minimizes duplication of audit effort.

- A. I and II only.
- B. I and IV only.
- C. II and III only.
- D. III and IV only.

**Answer: B**

**QUESTION: 70**

An audit to test the system of controls over the purchase, distribution, and use of radioactive material is being conducted at a company's plants. The process is well documented, and employees in the safety department are very familiar with the department's procedures. Since the purchasing and facilities departments are involved in the process, the auditor is considering reviewing their radioactive material-handling procedures as well. The auditor should

- A. Have confidence in the rigorous and detailed safety department procedures, since that department has the main responsibility for radiation safety, and should not use audit time to review other departments.
- B. Adjust the engagement schedule and budget, if needed, and interview the appropriate individuals in the purchasing and facilities departments to ascertain whether additional controls exist that complement those identified within the safety department.
- C. Test the controls identified within the safety department; if results are unfavorable, the auditor should consider whether to involve the other departments.
- D. Defer questions regarding purchasing, facilities, and other departments until audit projects can be scheduled for those departments.

**Answer: B**

**QUESTION: 71**

According to the International Professional Practices Framework, which of the following would be considered a scope limitation?

- I. Divisional management indicates that since the division is in the process of converting a major computer system, the information systems portion of the planned audit will have to be postponed until next year.
- II. The audit committee reviews the audit plan for the year and deletes an audit that the director thought was important to conduct.
- III. The sales manager indicates that certain customers cannot be contacted because the



organization is in the process of negotiating a long-term contract with them.

- A. I only.
- B. II only.
- C. I and III only.
- D. II and III only.

**Answer:** C

**QUESTION:** 72

While researching a topic during a telecommunications audit, an auditor identified a security vulnerability with the entity's revenue accounting system. The accounting system is outside the scope of the current audit engagement. The auditor should

- A. Disregard the security vulnerability and address it during the audit of the revenue accounting system.
- B. Include the revenue accounting system in the scope of the current audit engagement and address the vulnerability in the report.
- C. Alert management to the identified security vulnerability.
- D. Develop a solution to the security vulnerability and then inform management.

**Answer:** C

**QUESTION:** 73

Which statement most accurately describes how criteria are established for use by internal auditors in determining whether goals and objectives have been accomplished?

- A. Management is responsible for establishing the criteria.
- B. Internal auditors should use professional standards or government regulations to establish the criteria.
- C. The industry in which a company operates establishes criteria for each member company through benchmarks and best practices for that industry.
- D. Appropriate accounting or auditing standards, including international standards, should be used as the criteria.

**Answer:** A

**QUESTION:** 74

If an engagement client's operating standards are vague and thus subject to interpretation, the auditor should

- A. Seek agreement with the client as to the standards to be used to measure operating performance.

- B. Determine best practices in the area and use them as the standard.
- C. Interpret the standards in their strictest sense because standards are otherwise only minimum measures of acceptance.
- D. Omit any comments on standards and the client's performance in relationship to those standards, because such an analysis would be meaningless.

**Answer:** A

**QUESTION: 75**

Which of the following does not describe a skill or knowledge necessary to supervise a particular audit engagement?

- A. The ability to review and analyze an engagement program to determine if the proposed audit procedures will result in evidence relevant to the engagement objectives.
- B. The ability to use risk assessment and other judgmental processes to develop an engagement plan and schedule for the department, and present the plan to the audit committee.
- C. The ability to assure that an engagement final communication is supported and accurate relative to the evidence documented in the engagement working papers.
- D. The ability to determine that staff auditors have completed the audit procedures and that engagement objectives have been met.

**Answer:** B

**QUESTION: 76**

Which of the following statements regarding an internal auditor's responsibility for detecting fraud is not correct?

- A. The auditor should detect fraud if red flags are present.
- B. The auditor should have sufficient knowledge to correctly identify indicators that fraud may have been committed.
- C. The auditor should identify control weaknesses which could allow fraud to occur.
- D. The auditor should evaluate the indicators of fraud sufficiently to determine if a fraud investigation should take place.

**Answer:** A

**QUESTION: 77**

A fleet maintenance division uses a different code for each type of inventory transaction. A daily summary report lists activity by part number and transaction code. The report is reconciled by the parts room supervisor to the day's material request forms and is then forwarded to the fleet manager for approval. An auditor is considering an

analytical review of transaction codes and materials used. One objective of this review might be to

- A. Provide evidence of inventory items that are overstocked.
- B. Reveal shortages in perpetual inventory records.
- C. Determine whether inventory items are properly valued.
- D. Identify possible material lost due to employee theft.

**Answer:** D

**QUESTION:** 78

While analyzing substantial increases in the cost of goods sold, an auditor for a retail organization notes that payments to certain vendors appear to be unusually high. Which of the following procedures would be least effective in investigating possible kickbacks to purchasing agents?

- A. Confirm all contract terms and specifications with vendors.
- B. Analyze, by purchasing agent, all increases in costs of procured goods from specific vendors.
- C. Select a statistical sample of goods purchased and compare purchase prices with those of other sources of similar goods.
- D. Consider any changes in the lifestyles or individual consumption habits of the purchasing agents.

**Answer:** A

**QUESTION:** 79

A manufacturer uses a materials requirements planning (MRP) system to track inventory, orders, and raw materials requirements. What condition should an auditor search for in the MRP database if a preliminary assessment indicated that inventory is understated?

- I. Item cost set at zero.
- II. Negative quantities on hand.
- III. Order quantity exceeding requirements.
- IV. Inventory lead times exceeding delivery schedule.

- A. I and II only.
- B. I and IV only.
- C. II and IV only.
- D. III and IV only.

**Answer:** A

**QUESTION: 80**

During the preliminary survey phase of an audit of the purchasing function, an auditor determines that the procurement policy requires either quotes or formal bids, depending on the amount of the purchase. Which procedure should be performed to determine if fieldwork for policy compliance is necessary?

- A. Develop a five-year trend analysis of the purchasing department's expenses.
- B. Determine the volume of purchase orders processed for the audit period.
- C. Determine the volume of contracts awarded for the audit period.
- D. Chart the purchases made for the audit period by type and dollar amount.

**Answer: D**

**QUESTION: 81**

When the internal audit activity lacks the expertise to perform a specific engagement, the chief audit executive (CAE) should

- A. Negotiate with management to remove from the scope any portion of the audit that the staff is unable to perform.
- B. Use external resources with sufficient expertise to accomplish the engagement.
- C. Postpone the engagement until the CAE can hire a new internal auditor with the relevant skills.
- D. Continue with the engagement but rely on management's self-assessment in the areas where the audit staff lacks expertise.

**Answer: B**

**QUESTION: 82**

Which of the following risk factors is generally the most important for an internal auditor to consider when planning an assurance engagement for a department?

- A. The quality of the department's internal control system.
- B. The liquidity of the department's assets.
- C. The results of previous audit engagements for that division.
- D. The diversification of risk in the industry.

**Answer: A**

**QUESTION: 83**

Which of the following describes the activity of trading futures with the objective of reducing or controlling risk?

- A. Insuring
- B. Hedging.
- C. Short-selling.
- D. Factoring.

**Answer:** B

**QUESTION:** 84

Which of the following factors should an internal auditor consider when planning an audit of an activity?

- A. The objectives of the activity, the number of employees involved, and the control system.
- B. The qualifications of management, the significant risks, and the control system.
- C. The objectives of the activity, the significant risks, and the control system.
- D. The number of employees involved, the control system, and the recommendations of external auditors.

**Answer:** C

**QUESTION:** 85

Which of the following would be of the most assistance to a chief audit executive in prioritizing the annual audit plan?

- A. Risk assessment.
- B. Value-at-risk technique.
- C. Value-for-money approach.
- D. Control standards.

**Answer:** A

**QUESTION:** 86

A recently appointed chief audit executive (CAE) learns that the audit plan for the upcoming year prepared by the CAE's predecessor has only been reviewed by the audit committee. Which of the following would be the most appropriate action for the CAE to take next in order to gain management support for the audit plan?

- A. Send a copy of the entire audit plan to management of the areas to be audited, with specific assigned dates when the engagements will be conducted.

- B. Meet with management of each area to be audited and explain the purpose and scope of the audit engagement in their area.
- C. Plan for formal entry meetings and engagement letters at the beginning of each engagement and ensure that management understands all work to be undertaken.
- D. Proceed with the audit plan because it is already approved.

**Answer:** B

**QUESTION:** 87

An internal audit activity that reports both functionally and administratively to the chief financial officer is more likely to

- A. Produce business-oriented and relevant findings.
- B. Have its audit independence questioned.
- C. Produce fewer audit recommendations.
- D. Have its recommendations implemented by management.

**Answer:** B

**QUESTION:** 88

An internal auditor would review prior audit reports when planning an audit engagement in order to

- I. Identify previously reported problem areas for further follow-up.
- II. Eliminate previously reviewed areas from further examination.
- III. Gain an understanding of the audited area's business processes and control activities.
- IV. Understand the concerns or requests of management.

- A. II only.
- B. I and III only.
- C. I and IV only.
- D. II and III only.

**Answer:** B

**QUESTION:** 89

Which of the following best describes the internal audit activity's role in supporting the board in enterprise-wide risk assessment?

- A. Ensure that sound risk management processes are in place and functioning.
- B. Oversee risk management processes to determine if they are adequate and effective.
- C. Examine, evaluate, report on, and recommend improvements on the adequacy and effectiveness of risk processes.
- D. Implement risk management methodologies and controls to address risks identified.

**Answer:** C

**QUESTION:** 90

Which of the following is the least appropriate action for an internal auditor to take in support of an organization's ethical culture?

- A. Assess the state of the ethical climate.
- B. Provide guidance to employees regarding ethical dilemmas.
- C. Evaluate the effectiveness of the organization's code of conduct.
- D. Determine the appropriateness of expected ethical attitudes and behaviors.

**Answer:** B

**QUESTION:** 91

Which of the following should an internal audit activity take into consideration when evaluating an organization's privacy framework?

- I. Types of information gathered by the organization.
- II. Methods used to collect and store information.
- III. Location and custody of key information.
- IV. Intended use of information that is collected and stored.

- A. I and III only.
- B. I, II, and IV only.
- C. II, III, and IV only.
- D. I, II, III, and IV.

**Answer:** D

**QUESTION:** 92

In addition to risk materiality, which of the following should be considered during the process of ranking and validating an organization's risk priorities?

- A. Possible financial loss.
- B. Competency of internal audit staff.
- C. Likelihood of risk occurrence.
- D. Liquidity of assets.

**Answer:** C

**QUESTION:** 93

According to the International Professional Practices Framework, which of the following criteria should be used to evaluate an organization's governance process?

- A. Risk, control activities, information, and monitoring.
- B. Strategies, policies, procedures, and operations.
- C. Values, goals, monitoring, and accountability.
- D. Regulations, rules, laws, and systems.

**Answer:** C

**QUESTION:** 94

An annual audit plan would be the primary method of identifying the internal audit activity's

- A. Authority.
- B. Resource needs.
- C. Reporting requirements.
- D. Independence.

**Answer:** B

**QUESTION:** 95

An organization's decision to outsource its computer systems support is an example of which of the following risk responses?

- A. Risk acceptance.
- B. Risk sharing.
- C. Risk avoidance.
- D. Risk reduction.

**Answer:** B

**QUESTION:** 96

An organization automatically compares the total number of transactions processed and passed from its online order-entry system to the number of transactions received in its billing system and calculates variances. This is an example of which of the following information technology controls?

- A. Logic test.
- B. Check digits.



- C. Data reasonableness tests.
- D. Balancing control activities.

**Answer: D**

**QUESTION: 97**

According to the Standards, which of the following should be defined in the internal audit charter?

- I. The internal audit activity's position within the organization.
- II. The audit activities to be performed during the upcoming year.
- III. The scope of internal audit activities.
- IV. Management and the board of directors' agreement regarding the roles and responsibilities of the internal audit activity.

- A. I and IV only.
- B. II and III only.
- C. I, III, and IV only.
- D. I, II, III, and IV.

**Answer: C**

**QUESTION: 98**

Which of the following would not compromise an internal auditor's objectivity?

- A. Preparing bank reconciliations.
- B. Reviewing procedures before they are implemented.
- C. Auditing an activity for which the auditor had responsibility in the past year.
- D. Providing both advisory services and audit services for a project.

**Answer: B**

**QUESTION: 99**

The most important reason for the chief audit executive to ensure that the internal audit department has adequate and sufficient resources is to

- A. Ensure that the function is adequately protected from outsourcing.
- B. Demonstrate sufficient capability to meet the audit plan requirements.
- C. Establish credibility with the audit committee and management.
- D. Fulfill the need for effective succession planning.

**Answer: B**

**QUESTION: 100**

If a department outside of the internal audit activity is responsible for reviewing a function or process, the internal auditors should

- A. Consider the work of the other department when assessing the function or process.
- B. Not consider the work of the other department and proceed with an independent audit.
- C. Reduce the scope of any audit of the function or process because a review has already been performed by the other department.
- D. Delegate the responsibility for assessing the function or process to the other department.

**Answer: A**

**QUESTION: 101**

Which statement is not true regarding the performance management process?

- A. Staff specialists own the process in order to ensure implementation and accountability.
- B. Subordinates and superiors have shared responsibility for managing the process.
- C. Performance management is linked to competence and knowledge management.
- D. Performance management is integrated into other organizational and human resource processes.

**Answer: A**

**QUESTION: 102**

Which of the following environments is most likely to help prevent fraud within an organization?

- I. Realistic organizational goals and objectives have been set.
- II. Legal counsel is available for consultation on a timely basis.
- III. Procedures exist to investigate fraud when it is identified.
- IV. A well-designed control system exists.

- A. I and II only.
- B. I and IV only.
- C. II and III only.
- D. III and IV only.

**Answer: B**

**QUESTION: 103**

Which of the following is an objective of internal control?

- A. Reconciliation.
- B. Accuracy.
- C. Segregation of duties.
- D. Authorization.

**Answer: B**

**QUESTION: 104**

An internal audit activity encounters a scope limitation from senior management that will affect its ability to meet its goals and objectives for a potential engagement client. The nature of the scope limitation should be

- A. Noted in the audit workpapers, but the engagement should be carried out as scheduled, with any necessary adjustments made based on the scope limitation.
- B. Communicated to the external auditors so that they can investigate the area in more detail.
- C. Communicated, preferably in writing, to the board.
- D. Communicated to management, stating that the limitation will not be accepted because it would impair the audit activity's independence.

**Answer: C**

**QUESTION: 105**

Which of the following situations allows for the most objectivity on the part of an internal auditor?

- A. Assessing testing procedures in a new computer system.
- B. Performing a risk assessment of a new financial instrument.
- C. Drawing conclusions from a sample of financial transactions.
- D. Comparing current environmental activities against legislation.

**Answer: D**

**QUESTION: 106**

After several years in the engineering department, an engineer was transferred to the internal audit department. One month later, the new auditor was assigned to an

assurance engagement for the engineering department. When the auditor's former engineering supervisor suggested a change in the sample selection method, the auditor consulted with the audit supervisor. They determined that the suggested method would not be as representative and that the original selection method should be used. In this situation, the auditor

- A. Maintained an independent mental attitude and is therefore objective.
- B. Has subordinated professional judgment, and objectivity is therefore impaired.
- C. Does not have objectivity since the auditor recently transferred from the engineering department.
- D. Does not have independent organizational status since the auditor recently transferred from the engineering department.

**Answer: C**

**QUESTION: 107**

To assure that the technical proficiency of internal auditors is appropriate for the audit engagements to be performed, a chief audit executive should

- A. Consider the scope of work and level of responsibility when establishing criteria for education and experience in filling internal auditing positions.
- B. Ensure that each newly hired auditor is qualified in all of the disciplines needed to accomplish the department's audit mission.
- C. Oversee a training program that matches the actual training provided with the interests of individual auditors.
- D. Require all of the audit staff to pursue a minimum number of Continuing Professional Education hours each year.

**Answer: A**

**QUESTION: 108**

In order to exercise due professional care as defined in the International Professional Practices Framework, an internal auditor should

- I. Consider the probability of significant noncompliance in each audit engagement.
- II. Perform assurance procedures with sufficient care to ensure that all risks are identified.
- III. Weigh the cost of assurance against the benefits.

- A. I and II only.
- B. I and III only.
- C. II and III only.
- D. I, II, and III.

**Answer: B**

**QUESTION: 109**

An internal auditor audited a department store's cash function. Which of the following actions would indicate a lack of due professional care by the auditor?

- A. Based on a well-designed system of internal controls over the cash function, the audit report assured senior management that no irregularities existed.
- B. A flowchart of the entire cash function was developed but only samples of transactions were tested.
- C. The audit report included a well-supported recommendation for a reduction in staff even though such a reduction might adversely impact morale.
- D. The auditor informed appropriate authorities within the organization about suspected wrongdoing but did not inform external authorities.

**Answer: A**

**QUESTION: 110**

In order to save time, an audit manager no longer required that a standard internal control questionnaire be completed for each audit engagement. Does this represent a violation of the Standards?

- A. Yes, because internal control should be evaluated on every engagement and the internal control questionnaire is the mandated approach to evaluate controls.
- B. Yes, because internal control should be evaluated on every engagement and the internal control questionnaire is the most efficient method to do so.
- C. No, because auditors may omit necessary procedures if there is a time constraint, based on audit judgment.
- D. No, because auditors are not required to complete internal control questionnaires on every engagement.

**Answer: D**

**QUESTION: 111**

The chief commodity trader for a large energy company learns from a friend that a competitor will likely fail its upcoming regulatory audit and will be forced to temporarily decrease production. If the information is true, the trader has short-term opportunities to make trades that will financially benefit the trader's company and will lead to a substantial increase in the trader's performance bonus. However, if the information is not true, making the trades will significantly increase the company's risk of being caught in a long position. From an ethical perspective, which of the following would be the most appropriate course of action for the trader to take?

- A. Make the trade because the company and the trader will both benefit.
- B. Have another trader on staff make the trade in order to avoid a conflict of interest.
- C. Disclose the information to the risk oversight committee but proceed with the trade to capitalize on the opportunity.
- D. Defer the decision to management and risk the loss of the trading opportunity.

**Answer:** D

**QUESTION:** 112

An internal auditor pays to participate in the company's annual golf tournament, which is held outside of normal business hours. The auditor wins the putting contest and is awarded an all-expense-paid weekend vacation. According to the IIA Code of Ethics regarding objectivity, the auditor's best course of action would be to

- A. Refuse the prize because the amount is significant.
- B. Accept the prize because the event was held outside of normal business hours.
- C. Refuse the prize because it represents an impairment to objectivity.
- D. Accept the prize because the auditor received no special treatment.

**Answer:** D

**QUESTION:** 113

Risk assessments are valuable to the internal audit activity's planning process because they assist in

- A. Eliminating all areas with low risk from the audit plan.
- B. Educating management on the importance of keeping the internal audit activity informed of organizational changes.
- C. Identifying the audit universe or auditable activities that need to be reviewed.
- D. Identifying risks that management and the internal auditors have overlooked.

**Answer:** C

**QUESTION:** 114

Which of the following audit activities is within the scope of assurance activities as stated in the International Professional Practices Framework?

- A. Review a make-or-buy decision and report a recommendation to management for approval.
- B. Participate in negotiations for a corporate acquisition.
- C. Assess financing alternatives for a new generator.
- D. Perform an evaluation of management's planning process.

**Answer:** C

**QUESTION:** 115

Which of the following would be the most useful in developing an annual audit plan?

- A. General purpose audit software.
- B. Voting software and hardware.
- C. Flowcharting and data capture software.
- D. Risk assessment software.

**Answer:** D

**QUESTION:** 116

Which of the following is true with respect to the risk assessment process?

- A. The ethical climate should not be included since this factor cannot be measured quantitatively.
- B. More than one risk factor may have to be used to ensure that the risk assessment is comprehensive.
- C. Each risk factor should be given equal weighting in order to reduce the opportunity for bias.
- D. The risk assessment process should be conducted at least every three years.

**Answer:** B

**QUESTION:** 117

A quantitative risk assessment model has all of the following advantages except

- A. Accommodating a large number of risk factors in the assessment.
- B. Providing documentation for the chief audit executive, who must defend the long-range audit plan.
- C. Providing a systematic method of applying weightings to risks and priorities.
- D. Removing the need for judgment on the part of the chief audit executive.

**Answer:** D

**QUESTION:** 118

Which of the following statements is correct regarding risk analysis?

- A. The extent to which management judgments are required in an area could serve as a risk factor in assisting the auditor in making a comparative risk analysis.
- B. The highest risk assessment should always be assigned to the area with the largest potential loss.
- C. The highest risk assessment should always be assigned to the area with the highest probability of occurrence.
- D. Risk analysis must be reduced to quantitative terms in order to provide meaningful comparisons across an organization.

**Answer:** A

**QUESTION:** 119

Which of the following is the primary concern of an internal auditor in a comprehensive audit of an organization?

- A. Accuracy of reports on the source and use of funds.
- B. Extent of achievement of the organization's mission.
- C. Confirmation of compliance with policies and procedures.
- D. Appropriateness of procedures related to the budgeting process.

**Answer:** B

**QUESTION:** 120

Management should be included in the development of the audit plan in order to

- A. Provide assurance that past audit recommendations have been properly implemented.
- B. Select the audit tests that will be used for each engagement.
- C. Verify that the highest risks are included in the risk-based audit plan.
- D. Guarantee access to the organization's sites and records for audit work.

**Answer:** C

**QUESTION:** 121

When developing the annual audit plan and reviewing risk assessment priorities, a chief audit executive should always identify the

- A. Potential recommendations for each auditable activity.
- B. Persons to whom engagement reports will be communicated.
- C. Engagement procedures to be used during the engagements.
- D. Internal audit resources required to achieve the audit plan.



**Answer:** D

**QUESTION:** 122

Overall audit efficiency is enhanced between the internal and external audit functions when

- A. Internal audit coverage is reduced to avoid potential conflicts of interest.
- B. Audits of the same department are conducted at different times.
- C. The internal audit department reviews functions or departments prior to the external audit.
- D. External audit scope is reduced based on the internal audit department's activities.

**Answer:** D

**QUESTION:** 123

A chief audit executive (CAE) is obtaining information required by a regulatory oversight body and discovers a situation that requires management to take immediate corrective action. What is the best course of action for the CAE to take?

- A. Wait until all of the information has been gathered and reported to the oversight body before reporting the situation to management.
- B. Check with legal counsel to determine whether the situation can be reported to management before all information has been submitted to the oversight body.
- C. Report the situation to management immediately.
- D. Schedule an engagement to explore the situation in depth, before reporting to either management or the oversight body.

**Answer:** C

**QUESTION:** 124

Which of the following should be included in the internal audit activity's annual plan?

- A. Degree of testing that will be required to achieve the plan's objectives.
- B. Scope of internal audit work and any limitations placed on that scope.
- C. Details of preliminary surveys to be carried out before each engagement.
- D. Procedures that will be used to conduct each planned engagement.

**Answer:** B

**QUESTION:** 125

A chief audit executive (CAE) believes that senior management has accepted a level of residual risk that is unacceptable to the organization. According to the Standards, the CAE must first discuss the matter with the organization's

- A. Senior management.
- B. Audit committee.
- C. External auditors.
- D. Board.

**Answer:** A

**QUESTION:** 126

A chief audit executive (CAE) has learned that a system currently being installed in the CAE's organization is identical to one that suffered a catastrophic failure in another organization. The CAE should

- A. Disregard the issue because there has been no audit work undertaken or any type of reliable information provided.
- B. Notify senior management and request that the installation be halted.
- C. Add the issue to the annual audit plan and schedule an engagement when time is available.
- D. **Investigate the issue further** even though there is no provision in the audit plan for this work.

**Answer:** D

**QUESTION:** 127

Assessments of the independence of an organization's external auditors should

- I. Be carried out only when the external auditor is appointed.
- II. Be carried out when the external auditor is appointed and regularly thereafter.
- III. Not include any participation by the internal audit activity.
- IV. Include participation by the internal audit activity.

- A. I and III only.
- B. I and IV only.
- C. II and III only.
- D. **II and IV only.**

**Answer:** D

**QUESTION:** 128

Which of the following is the most important limitation on the effectiveness of audit committees?

- A. Audit committees may be composed of independent directors; however, those directors may have close personal and professional friendships with management.
- B. Audit committee members are compensated by the organization and thus favor a stockholder view.
- C. Audit committees devote most of their efforts to external audit concerns and do not pay much attention to internal auditing and the overall control environment.
- D. Audit committee members do not normally have degrees in the accounting or auditing fields.

**Answer:** A

**QUESTION:** 129

Which of the following management actions would be most effective in order to strengthen ethical awareness within an organization?

- A. Require employees to certify that they have read and understand the organization's code of conduct.
- B. Ensure that all employees pass a criminal background check prior to being hired.
- C. Mandate that employees follow documented departmental procedures and processes.
- D. Request that the internal audit activity test departments with a higher risk of employee fraud.

**Answer:** A

**QUESTION:** 130

An internal auditor has been asked to review the treasury department's compliance with corporate policy related to the use of forward trading to manage currency valuation risk. The auditor finds no related policies in the corporate policy manual but does discover that the department is following a policy developed by the company's bank. The most appropriate response from the auditor would be to

- A. Withdraw from the audit engagement because there is nothing to audit due to the lack of a corporate policy.
- B. Perform no further audit work and report the lack of a corporate policy as an audit observation.
- C. Postpone the audit engagement until a corporate policy can be established.
- D. Use the bank's policy as the audit criteria and determine whether formal adoption should be recommended in the engagement final communication.

**Answer:** D

**QUESTION:** 131

During an audit engagement, an internal auditor finds that management is not complying with previous commitments made to the external auditors. However, the auditor determines management's actions to be justified due to significant changes in the business. The best course of action for the auditor to take would be to

- A. Proceed with the audit engagement and **assess the changes** actually implemented by management.
- B. Inform the external auditors and seek their guidance.
- C. Inform the external auditors and remove the associated work from the internal audit scope.
- D. Compare the recommended changes against the changes made by management and advise management which action to take.

**Answer:** A

**QUESTION:** 132

Which of the following actions taken by management would most likely improve an organization's **moral climate**?

- A. Making changes in organizational policies.
- B. Promoting changes in employee attitudes.
- C. Evaluating the organization's moral climate.
- D. Modeling appropriate behavior in the workplace.**

**Answer:** D

**QUESTION:** 133

In addition to data protection, which of the following is a control that is typically used by companies to safeguard the privacy rights of their customers?

- I. End-user computing.
- II. Encryption of data.**
- III. Spyware.
- IV. Intrusion detection.**

- A. II only.
- B. I and III only.
- C. II and IV only.**
- D. I, II, and IV only.

**Answer:** C

**QUESTION:** 134

When reviewing the information security in an organization, an internal auditor should always recommend to management the strongest security system that is compatible with the organization's

- A. Willingness to incur security costs.
- B. Business practices and risk factors.
- C. Existing technical and staff competencies.
- D. Understanding of security weaknesses.

**Answer:** B

**QUESTION:** 135

Which of the following best describes the procedures used by the representatives of an organization's stakeholders to provide oversight of the processes administered by management?

- A. Governance.
- B. Control.
- C. Risk management.
- D. Monitoring.

**Answer:** A

**QUESTION:** 136

Which of the following statements regarding organizational governance is not correct?

- A. An effective internal audit function is one of the four cornerstones of good governance.
- B. Those performing governance activities are accountable to the customer.
- C. Accountability is one of the key elements of organizational governance.
- D. Governance principles and the need for an internal audit function are applicable to governmental and not-for-profit activities.

**Answer:** B

**QUESTION:** 137

Why is the concept of residual risk important?

- A. Because residual risk is difficult to measure.
- B. Because residual risk is all of the risk that remains after controls are established.
- C. Because the cost-benefit analysis supporting control design is part of the measure of residual risk.
- D. Because the risk that remains after control design and implementation needs to be acceptable to senior management.

**Answer:** D

**QUESTION:** 138

A major difference between enterprise risk management and traditional risk management lies in the narrow focus of traditional risk management on

- I. Property and liability risks.
- II. Risks with insurance solutions.
- III. Risks impacting organizational objectives.

- A. I and II only.
- B. I and III only.
- C. II and III only.
- D. I, II, and III.

**Answer:** A

**QUESTION:** 139

When an external auditor unknowingly fails to modify an opinion on financial statements that are materially misstated, this is an example of

- A. An inherent risk.
- B. A control risk.
- C. An audit risk.
- D. A residual risk.

**Answer:** C

**QUESTION:** 140

In the annual audit of the financial statements of a company with high inherent risk and a very strong control system, the external auditor may be able to allow detection risk to rise because

- A. Audit risk has been reduced.
- B. Control risk has been assessed at a lower level.

- C. The company's operations are very susceptible to misstatements.
- D. Whenever inherent risk is high, control risk is disregarded.

**Answer:** B

**QUESTION:** 141

The first stage in the development of a crisis management program is to

- A. Formulate contingency plans.
- B. Conduct a risk analysis.
- C. Create a crisis management team.
- D. Practice the response to a crisis.

**Answer:** B

**QUESTION:** 142

Organizations that use a highly structured command-and-control management approach are at greater risk of

- A. Delayed response due to the inability to reach consensus among decision makers.
- B. Negative consequences that result from lower-level staff's unwillingness to confront errors by superiors.
- C. Erosion of staff morale due to perceptions of ineffective leadership.
- D. Waste and abuse of organizational resources resulting from management override of controls.

**Answer:** B

**QUESTION:** 143

Of the following reasons for employees to resist a major change in organizational processes, which is least likely?

- A. Threat of job loss.
- B. Required attendance at training classes.
- C. Breakup of existing work groups.
- D. Imposition of new processes by senior management without prior discussion.

**Answer:** B

**QUESTION:** 144

When significant change is required, management is least likely to be able to change the organization's

- A. Members.
- B. Structure.
- C. Environment.
- D. Technology.

**Answer:** C

**QUESTION:** 145

Which of the following is not an appropriate control related to sales in a manufacturing company?

- A. Customers' orders are recorded promptly.
- B. Goods shipped are matched with valid customer orders.
- C. Goods returned are inspected for damage by the sales department and then entered into inventory.
- D. Credit department approval is required for credit sales transactions.

**Answer:** C

**QUESTION:** 146

The percentage of orders that are rush orders and the percentage of returns to total orders are examples of which of the following types of control activities?

- A. Quality control monitoring.
- B. Direct functional management.
- C. Benchmarking.
- D. Performance indicators.

**Answer:** D

**QUESTION:** 147

The best reason for separating the cash-receiving function from the related record-keeping function is to

- A. Segregate cash payments from cash receipts.
- B. Provide accountability for cash received.



**C. Minimize misappropriations in cash receipts.**

D. Improve physical security over the cash-receiving function.

**Answer: C**

**QUESTION: 148**

Which of the following would be the least effective in preventing purchasing agents from taking kickbacks or gifts from vendors in exchange for favorable contracts?

A. A specific corporate policy prohibiting the acceptance of anything of value from a vendor.

B. A corporate code of ethics prohibiting any activity that might impair objectivity.

C. A requirement for purchasing agents to develop a company **profile of each new** vendor before it is added to the authorized vendor list.

D. The establishment of long-term contracts with major vendors, with the contract terms approved by senior management.

**Answer: C**

**QUESTION: 149**

Which of the following lists the audit activities in the order in which they would generally be completed during a preliminary survey?

I. Write detailed audit procedures.

II. Identify client objectives, goals, and standards.

III. Identify risks and controls intended to prevent associated losses.

IV. Determine relevant engagement objectives.

A. II, I, IV, III.

**B. II, III, IV, I.**

C. III, IV, II, I.

D. II, IV, I, III.

**Answer: B**

**QUESTION: 150**

An audit of the quality control department is being planned. Which of the following would least likely be used in the preparation of a preliminary survey questionnaire?

**A. An analysis of quality control documents.**

B. The permanent audit file.

C. The prior audit report.

D. Management's charter for the quality control department.

**Answer:** A

**QUESTION:** 151

An objective for an audit of a medical research corporation is to evaluate management's controls to ensure that timely reports are submitted to sponsors of contracted research projects. In planning the audit to achieve this objective, the auditor should begin by

- A. Reviewing policies and procedures.
- B. Interviewing a group of research managers.
- C. Observing report preparation in a number of laboratories.
- D. Sending a questionnaire to a sample of research sponsors.

**Answer:** A

**QUESTION:** 152

Which of the following internal control weaknesses would an auditor most likely detect while reviewing a flowchart that depicts the purchasing function of an organization?

- A. Purchasing policies have not been updated.
- B. The organization is not taking advantage of quantity discounts available from its suppliers.
- C. Payments for goods received have not been authorized at the appropriate level.
- D. Payments to suppliers are made **before goods are received.**

**Answer:** D

**QUESTION:** 153

Inadequate risk assessment would have the strongest negative impact in which of the following phases of an audit engagement?

- A. Determining the scope.**
- B. Reviewing internal controls.
- C. Testing.
- D. Evaluating findings.

**Answer:** A

**QUESTION:** 154

An organization has a policy requiring two signatures on all checks written for amounts in excess of \$10,000. When evaluating controls over disbursements, an auditor would conclude that a greater risk exists if

- A. The auditor located two checks for \$9,000 each that contained one authorized signature.
- B. The \$10,000 was an immaterial amount to the organization and very few cash disbursements required an amount in excess of \$10,000.
- C. The director of accounting was not one of the authorized signers.
- D. There were several instances in which **successively numbered checks** for amounts between \$5,000 and \$10,000 were made payable to the **same vendor**.

**Answer:** D

**QUESTION:** 155

Which of the following corporate travel policies is least likely to be cost-effective?

- A. Negotiating corporate agreements with hotels, airlines, and car rental firms.
- B. Tracking credits for canceled airline reservations.
- C. Selecting the least expensive airline travel available, **without regard to total travel time and distance**.
- D. Traveling to facilities in tourist areas during the off-season when possible.

**Answer:** C

**QUESTION:** 156

Which of the following is a **control weakness** that allows for the greatest probability of fraud?

- A. The log-on accounts for the computerized information management system are not immediately canceled for terminated employees.
- B. Scheduled physical counts to verify the perpetual inventory system are frequently delayed because of staff shortages and conflicting priorities.
- C. An employee is responsible for entering identifying information into the inventory database whenever supplies are delivered. A manager periodically compares inventory records with supplies on hand.
- D. **The employee who handles all cash sales has responsibility for balancing the cash register and making bank deposits.**

**Answer:** D

**QUESTION: 157**

In a manufacturing organization, all sales prices are determined centrally and are electronically sent to the distribution centers to update their sales price tables. Any pricing deviations must be approved by central headquarters. To determine how this process is functioning, an internal auditor should

- A. Document the flow of sales price information, and determine how the table is accessed and updated.
- B. Develop a flowchart of the sales order process to determine how orders are taken and priced.
- C. Identify who approves the shipment of goods and how the goods are priced.
- D. Obtain a copy of the existing flowchart for the computer program to determine how price data are accessed.

**Answer: A**

**QUESTION: 158**

To determine if a new computer system is improving the use of a manufacturer's limited facilities in serving the largest number of customers, an auditor should compare

- A. The number of reworked orders and their costs before and after system installation.
- B. Inventory and materials handling costs before and after system installation.
- C. The number of orders filled and their cycle times before and after system installation.
- D. The number of reworked orders and orders filled before and after system installation.

**Answer: C**

**QUESTION: 159**

A retail store uses a computerized perpetual inventory system with annual physical counts. The best approach for determining whether item counts in the perpetual inventory records are accurate at interim dates is to use generalized audit software to

- A. Generate stratified random samples of items for manual counting and compare counts to perpetual inventory records.
- B. Compare beginning and ending perpetual inventory counts after adjustment for sales and replenishments.
- C. Compute revised item count values by adjusting existing counts for spoilage and shrinkage.
- D. Simulate inventory transactions between physical inventory counts taken annually.

**Answer: A**

**QUESTION: 160**

Which of the following best describes the most important criteria when assigning responsibility for specific tasks required in an audit engagement?

- A. Auditors must be given assignments based primarily upon their years of experience.
- B. All auditors assigned an audit task must have the **knowledge and skills** necessary to complete the task satisfactorily.
- C. Tasks must be assigned to the audit team member who is most qualified to perform them.
- D. All audit team members must have the skills necessary to satisfactorily complete any task that will be required in the audit engagement.

**Answer: B**

**QUESTION: 161**

Auditors 1, 2, and 3 work out of various offices. Each must be assigned to one, and only one, of three audit locations (A, B, or C). The cost of sending each auditor to each location is listed below

Audit Locations	Auditor 1	Auditor 2	Auditor 3
A	\$200	\$400	\$200
B	\$300	\$300	\$200
C	\$400	\$600	\$500

The minimum cost with which this assignment can be accomplished is

- A. \$800
- B. \$900
- C. **\$1,000**
- D. \$1,100

**Answer: B**

**QUESTION: 162**

In developing an appropriate work program for an audit engagement, the most important factor for an audit supervisor to consider is the

- A. Availability of records and data.
- B. **Potential impact of risks.**
- C. Capabilities of audit personnel.
- D. Time required to complete the engagement.

**Answer: B**

**QUESTION: 163**

Which of the following would an internal auditor consider when developing engagement objectives?

- I. **Estimated time to complete the engagement.**
- II. Probability of significant errors.
- III. **Risks, controls, and governance processes.**

IV. Budgeted cost and resource requirements.

- A. II only.
- B. I and IV only.
- C. I and III only.
- D. I, III, and IV only.

**Answer:** C

**QUESTION:** 164

Coordination between the internal auditors and the external auditors tends to

- A. Increase risks due to potential communication issues arising from internal auditors' allegiance to the company.
- B. Decrease risks due to the internal auditors' knowledge of the company and industry.
- C. Increase risks due to differing views on the nature and adequacy of internal controls.
- D. Decrease risks by using internal auditors to perform low-level external audit testing.

**Answer:** B

**QUESTION:** 165

A manufacturer of very expensive precision optical equipment has experienced a significant increase in production costs over the past three months. The plant manager has demanded an immediate audit to identify the cause of the increases. Which of the following is true regarding this request?

- A. The chief audit executive (CAE) may accept the request but is not obligated to act upon it.
- B. The CAE should decline the request because the plant manager is not authorized to make audit requests.
- C. According to the Standards, only audits approved by the audit committee may be performed.
- D. Accepting the request would jeopardize the integrity of the existing audit plan.

**Answer:** A

**QUESTION:** 166

In which order should an environmental auditor audit the following manufacturing plants?

Factor	Hazard rating	Prior audit results	Plant population
Plant 1	Medium	Average	Small

Plant 2	High	Poor	Medium
Plant 3	Low	Good	Large

- A. 1, 2, 3.
- B. 1, 3, 2.
- C. 2, 1, 3.**
- D. 2, 3, 1.

**Answer:** C

**QUESTION:** 167

A large financial services firm has a formal privacy policy and recently hired a chief privacy officer. Since the new chief privacy officer has taken over, risk assessments have been performed, priorities have been established, and resources have been allocated to ensure that effective and consistent privacy controls could be implemented and maintained throughout the company. Based on the Capability Maturity Model (CMM), what level of maturity has the firm reached regarding its privacy strategy?

- A. Defined.**
- B. Managed.
- C. Repeatable.
- D. Optimized.

**Answer:** A

**QUESTION:** 168

Which of the following is an appropriate management strategy for supporting an organization's code of conduct?

- I. Offering training opportunities for all employees on ethics topics.
- II. Surveying employees, suppliers, and customers regarding compliance.
- III. Using case studies and examples of appropriate and inappropriate behaviors.
- IV. Establishing clear delineation of responsibilities throughout the organization.

- A. II and IV only.
- B. I, II, and III only.
- C. I, III, and IV only.
- D. I, II, III, and IV.

**Answer:** D

**QUESTION:** 169

Which of the following factors should internal auditors consider when planning an audit

engagement?

- I. The extent of documentation required to complete the engagement.
- II. Objectives of the area to be reviewed and how activities are controlled.
- III. Significant risks, resources, and operations.
- IV. Scope and degree of testing required to achieve the engagement's objectives.

- A. I and IV only.
- B. I, II, and III only.
- C. II, III, and IV only.
- D. I, II, III, and IV.

**Answer:** C

**QUESTION:** 170

A chief audit executive (CAE) decides to implement a quality assurance and improvement program for the internal audit department but encounters some resistance from internal audit staff concerning how the program should be monitored. Internal audit staff would prefer that all monitoring be performed through supervision during an audit engagement. The CAE needs to include in the monitoring program periodic quality assessments by staff independent from the audit engagement. How should the CAE promote the quality assessment concept?

- A. Encourage all internal audit staff to see the independent quality assessments as part of a process to continuously improve the internal audit department's performance.
- B. Explain that independent quality assessments will identify those staff whose performance does not meet the requirements of the internal audit department.
- C. Arrange for internal audit staff to be given appropriate training in all audit engagement procedures.
- D. Tell internal audit staff that the only purpose of the independent quality assessments is to ensure that errors are corrected quickly before reports are issued.

**Answer:** A

**QUESTION:** 171

According to the Standards, results of the internal audit activity's internal and external quality program assessments must be communicated to the board or governing body in order to

- A. Provide accountability and transparency in the management and supervision of internal audit work.
- B. Ensure that action is taken by internal audit staff to correct all quality non-conformances in internal audit work.



- C. Motivate internal audit staff to conform with all quality systems used in their internal audit work.
- D. Demonstrate that all internal audit staff have been instructed in the importance of quality in internal audit work.

**Answer:** A

**QUESTION:** 172

In promoting quality assurance and improvement of the internal audit activity, which of the following would be considered a component of ongoing assessment?

- I. Supervision.
- II. Feedback from audit customers.
- III. Analysis of performance measures.
- IV. Comparison of budgeted to actual audit hours.

- A. I and III only.
- B. II and IV only.
- C. I, III, and IV only.
- D. I, II, III, and IV.

**Answer:** D

**QUESTION:** 173

Which of the following is a recognized scheme for procurement fraud?

- I. Change-order abuse.
- II. Collusive bidding by contractors.
- III. Collateral financing.

- A. I only.
- B. I and II only.
- C. II and III only.
- D. I, II, and III.

**Answer:** B

**QUESTION:** 174

The decision to implement enhanced failure detection and back-up systems to improve data integrity is an example of which risk response?

- A. Risk acceptance.
- B. Risk sharing.
- C. Risk avoidance.

**D. Risk reduction.**

**Answer: D**

**QUESTION: 175**

In selecting assurance engagements that are consistent with an organization's goals, the chief audit executive would most likely give highest priority to

- A. Results of prior audits in potential engagement areas.
- B. Opportunities to achieve operating benefits.
- C. Requests by senior management.
- D. Assessments of risk and effectiveness of risk management.

**Answer: D**

**QUESTION: 176**

Conflict triggers include all of the following except

- A. Unclear job boundaries.
- B. Unrealized expectations.
- C. Status differentials.
- D. Superordinate goals.**

**Answer: D**

**QUESTION: 177**

The use of pre-employment background checks is what type of control?

- A. Preventive.
- B. Detective.
- C. Corrective.
- D. Directive.

**Answer: A**

**QUESTION: 178**

According to the Standards, which of the following should be addressed as a planning consideration?

- A. Safeguarding of assets in the activity being audited.
- B. Compliance of operations with policies, plans, procedures, laws, and regulations.
- C. Accomplishment of established objectives and goals for operations and programs.
- D. Objectives of the activity being audited.

**Answer:** D

**QUESTION:** 179

According to the International Professional Practices Framework, which of the following is an acceptable method of Continuing Professional Education?

- I. Attending college courses.
- II. Attending conferences and seminars.
- III. Joining and participating in professional societies.
- IV. Participating in research projects.

- A. I and III only.
- B. II and IV only.
- C. I, II, and III only.
- D. I, II, III, and IV.

**Answer:** D

**QUESTION:** 180

An internal auditor who is working at a company without an enterprise-wide risk management process should

- A. Discuss the need for a risk management process with management.
- B. Create and implement an audit risk assessment process as a substitute.
- C. Develop a risk management process for use by the board.
- D. Notify the external auditors of the lack of a risk management process.

**Answer:** A

**QUESTION:** 181

According to the International Professional Practices Framework, the most complete definition of controls is

- A. Processes and procedures that are designed to ensure that all transactions are properly authorized and accounted for.
- B. Policies and practices designed to ensure that assets are properly protected and that

operating and financial records have integrity.

C. Actions taken by management to manage risk and increase the likelihood that established objectives and goals will be met.

D. A management-designed accounting system and related procedures.

**Answer:** C

**QUESTION:** 182

During a meeting of an internal audit team, two members of the team disagree, and one accuses the other of trying to advance personal interests over the interests of the audit. The audit manager should

A. Discipline both auditors after the meeting for their lack of professional conduct.

B. Continue the meeting but speak to the accusing auditor later regarding the inappropriate conduct.

C. Meet with both auditors after the meeting to resolve the conflict and the inappropriate behavior.

D. Stop the meeting and refer the matter to the entire team for discussion.

**Answer:** C

**QUESTION:** 183

In order to ensure that the internal auditors have the objectivity required by the Standards, the chief audit executive should

A. Demonstrate willingness to include in engagement final communications all matters believed to be important.

B. Require all auditors to sign statements attesting to their independent mental attitudes and honest belief in their work product.

C. Carefully assign personnel to individual audit engagements and require auditors to disclose all conflicts of interest.

D. Appraise each auditor's performance on each audit assignment.

**Answer:** C

**QUESTION:** 184

It would be appropriate for an internal audit activity to use consultants with expertise in health-care benefits when the internal audit activity is

I. Conducting an audit of the organization's estimate of its liability for post retirement benefits, which include health care benefits.

II. Comparing the cost of the organization's health care program with that of other programs offered in the industry.

III. Training its staff to conduct an audit of health care costs in a major division of the

organization.

- A. I only.
- B. I and III only.
- C. II and III only.
- D. I, II, and III.

**Answer:** D

**QUESTION:** 185

Which of the following actions would be considered a violation of the Standards?

- I. Drafts of engagement communications were reviewed with the audit client to obtain input. The client's comments were considered when developing the engagement final communication.
- II. An auditor participated as part of a development team to review the control procedures to be incorporated into a major computer application under development.
- III. Given limited resources, the chief audit executive performed a risk analysis to determine which functions to audit.

- A. II only.
- B. I and III only.
- C. I, II, and III.
- D. None of the above.

**Answer:** D

**QUESTION:** 186

In an assurance engagement of treasury operations, an internal auditor is required to consider all of the following issues except

- A. The audit committee has requested assurance on the treasury department's compliance with a new policy on the use of financial instruments.
- B. Treasury management has not instituted any risk management policies.
- C. Due to the recent sale of a division, the amount of cash and marketable securities managed by the treasury department has increased by 350 percent.
- D. The external auditors have indicated some difficulties in obtaining account confirmations.

**Answer:** D

**QUESTION:** 187

Internal auditors exercise judgment about the type and amount of information to be collected. The primary purpose of this judgment is to

- A. Eliminate the risk of drawing incorrect conclusions.
- B. Minimize the cost of the audit engagement.
- C. Comply with the Standards.
- D. Provide a sound basis for audit observations and recommendations.

**Answer:** D

**QUESTION:** 188

According to the International Professional Practices Framework, a review team must express an opinion on which of the following when performing an external assessment of an internal audit activity?

- I. Conformance with the Standards and Code of Ethics.
- II. Effectiveness of continuous improvement activities.
- III. Feedback from internal audit customers and other stakeholder groups.
- IV. Efficiency and effectiveness of the internal audit activity's administration processes.

- A. I only.
- B. III only.
- C. I and II only.
- D. II and IV only.

**Answer:** A

**QUESTION:** 189

When planning the work program for an assurance engagement, an internal auditor should first review the department's business objectives and then

- A. Identify risks.
- B. Review controls.
- C. Determine scope.
- D. Evaluate vulnerabilities.

**Answer:** A

**QUESTION:** 190

When a risk assessment process has been used to construct an audit engagement schedule, which of the following should receive attention first?

- A. The external auditors have requested assistance for their upcoming annual audit.
- B. A new accounts payable system is currently undergoing testing by the information technology department.
- C. Management has requested an investigation of possible lapping in receivables.
- D. The existing accounts payable system has not been audited over the past year.

**Answer:** C

**QUESTION:** 191

Which of the following risk factors is most subjective?

- A. Changes in staff, systems, or the environment.
- B. Prior audit findings.
- C. Size of the unit being audited.
- D. Competency of operating management.

**Answer:** D

**QUESTION:** 192

Which of the following would provide the most reliable information on the risk associated with an auditable activity?

- A. Event scenarios with regression analysis.
- B. Past audit findings and instances of management failures.
- C. Consequences and economic predictability of loss.
- D. Management assessment and corroboration by the internal audit activity.

**Answer:** D

**QUESTION:** 193

The chairperson of an organization's audit committee has obtained a risk management report that identifies significant industry concerns that impact the organization. The chairperson has asked the chief audit executive (CAE) to review these concerns and advise if they are relevant to the organization. How should the CAE respond?

- A. Accept the engagement but communicate only with the audit committee to protect the confidentiality of the request.
- B. Decline the engagement because it is outside of the scope of the internal audit charter.
- C. Decline the engagement because it impairs the internal audit activity's independence.
- D. Accept the engagement but inform senior management of the request.

**Answer:** D

**QUESTION:** 194

Which of the following would have the least impact (either positive or negative) on an assessment of a department's control environment?

- A. The department managed long-term investments, including investment in derivatives and other financial instruments, to maximize return.
- B. The department manager sets a tone of honesty and integrity in all business dealings and this tone is emulated by department personnel.
- C. Many department functions were duplicated or verified by other department employees as part of the department's normal procedures.
- D. Audit tests designed to verify compliance with control procedures detected a general failure to follow standard procedures for transaction authorization.

**Answer:** A

**QUESTION:** 195

Which of the following is a benefit from **reduced testing** during a particular phase of an audit engagement?

- A. The size of the internal audit activity can be reduced.
- B. There is less concern about assessing inherent risk.
- C. The level of planned audit risk is lowered.
- D. Additional **audit hours** are available for pursuing other engagement objectives.

**Answer:** D

**QUESTION:** 196

An organization's external auditor has prepared a list of risks and issues and has recommended to senior management that the internal audit activity focus on these items. Senior management has forwarded the list to the chief audit executive (CAE). The CAE should

- A. Incorporate the external auditor's requirements into the internal audit plan.
- B. Ignore the external auditor's requirements because they are outside of the internal audit activity's planned scope of work.
- C. **Consider the issues raised by the external auditor for possible inclusion in the planned scope of work.**
- D. Report the risks and issues to the audit committee for possible future attention.



**Answer:** C

**QUESTION:** 197

A company has established its environmental audit activity as part of its legal department rather than part of its internal audit activity, which reports to the audit committee. The board has requested that the chief audit executive (CAE) provide an annual opinion on whether environmental risks are being properly addressed. In these circumstances, the CAE should recommend to the audit committee that **the internal audit activity**

- A. Review the recommendations in all environmental audit reports.
- B. Discuss with the environmental auditors the results of their reviews.
- C. Periodically carry out a quality assessment of the environmental audit activity.**
- D. Include a review of environmental issues in some internal audit engagements.

**Answer:** C

**QUESTION:** 198

Which aspect of the audit function would be most impacted by a lack of coordination between an organization's internal and external auditors?

- A. Responsiveness.
- B. Timeliness.
- C. Effectiveness.
- D. Efficiency.**

**Answer:** D

**QUESTION:** 199

A chief audit executive used risk assessment to prepare the audit work schedule. Which of the following would be the least appropriate reason to modify the schedule?

- A. Need for coordination of audit activities with the external auditors.
- B. Request for postponement since the audit would be too complicated.**
- C. Change in the relative risk of auditable activities during the year.
- D. Budget constraints or expansions.

**Answer:** B

**QUESTION:** 200

Due to urgent requests from management, a busy internal audit activity finds that it can no longer meet all of its commitments contained in the annual audit plan. The best course of action for the chief audit executive to take would be to

- A. Continue with the plan and seek opportunities to adjust priorities and reallocate resources.
- B. Advise senior management and request that they reconsider these additional requests using more rigorous risk assessment and prioritization factors.
- C. Advise the board and senior management and request a reassessment of the plan.**
- D. Advise the board immediately and seek their support for additional resources to meet the needs of the plan.

**Answer:** C

**QUESTION:** 201

The chief audit executive (CAE) routinely provides activity reports to the board during quarterly board meetings. Senior management has asked to review the CAE's board presentation before each board meeting so that any issues or questions can be discussed beforehand. The CAE should

- A. Provide the activity reports to senior management as requested and discuss any issues that may require action to be taken.
- B. Not provide activity reports to senior management because such matters are the sole province of the board.
- C. Disclose only those matters in the activity reports that pertain to expenditures and financial budgets of the internal audit activity.
- D. Provide information to senior management that pertains only to completed audit engagements and observations available in published engagement final communications.

**Answer:** A

**QUESTION:** 202

Reportable audit findings must be

- I. Documented by facts
- II. Supported by relevant evidence.
- III. Agreed to by management of the audited area.**
- IV. Convincing enough to compel corrective action.

- A. I and IV only.
- B. II and III only.
- C. I, II, and IV only.**
- D. I, II, III, and IV.

**Answer:** C

**QUESTION:** 203

Which of the following is not an appropriate role of the internal audit activity in governance activities?

- A. Support the board in enterprise-wide risk assessment.
- B. Ensure the timely implementation of audit recommendations.
- C. Monitor compliance with the organization's ethics policies.
- D. Discuss areas of significant risk.

**Answer:** B

**QUESTION:** 204

If management has not established a risk management process, the internal audit activity could

- A. Take a proactive role that supplements traditional assurance activities.
- B. Identify and mitigate risks to the organization.
- C. Assume responsibility for the management of identified risks.
- D. Assume primary responsibility for determining if adequate and effective processes are in place.

**Answer:** A

**QUESTION:** 205

The chief audit executive's responsibility regarding control processes includes

- A. Assisting senior management and the audit committee in the development of an annual assessment about internal control.
- B. Overseeing the establishment of internal control processes.
- C. Maintaining the organization's governance processes.
- D. Ensuring that the internal audit activity assesses all control processes annually.

**Answer:** A

**QUESTION:** 206

Regarding an organization's decision to retain an external audit firm, the chief audit executive (CAE) should

- A. Work with the organization's chief financial officer to evaluate the external auditor's performance and together make the decision.
- B. Not be involved in this decision process as it would compromise the CAE's objectivity.
- C. Evaluate the external auditor's performance and retain the external auditor if quality and cost criteria are met.
- D. Assist the audit committee by facilitating the development of an appropriate evaluation process.

**Answer:** D

**QUESTION:** 207

The primary role of the internal audit activity in regard to an organization's ethical climate is to

- A. Participate as chief ethics officer.
- B. Periodically assess the ethical climate.
- C. Utilize surveys to evaluate employee ethics.
- D. Demonstrate ethical behavior.

**Answer:** B

**QUESTION:** 208

Which of the following factors related to an organization's performance management system would not contribute to the organization's success?

- A. Performance management is linked to competence and knowledge management.
- B. Subordinates and superiors have shared responsibility for the performance management process.
- C. Staff members own the performance management process, thereby ensuring implementation and accountability.
- D. Performance management is integrated into other organizational processes and human resource processes.

**Answer:** C

**QUESTION:** 209

Which of the following actions by a chief audit executive would be most effective in preventing fraud?

- A. Ensure that the board is aware of all fraud that has been identified or reported.
- B. Train the internal audit staff in identifying fraud indicators.
- C. Review the adequacy of all policies that describe prohibited activities.
- D. Submit an annual report to the board on all fraud that has been detected.

**Answer:** C

**QUESTION:** 210

Which of the following should be the primary objective of an audit of an entity's business continuity plan?

- A. Cost of testing and updating the plan.
- B. Delegation of responsibilities for the plan.
- C. Relationship of the plan to risk exposures.
- D. Efficiency of the planning procedures.

**Answer:** C

**QUESTION:** 211

Which of the following elements is important for an internal auditor to consider when performing a privacy risk assessment of an organization?

- I. Areas where personal information is collected, used, stored, and disseminated.
- II. Inherent risk.
- III. Privacy practices of competitors.
- IV. Third-party recipients of information.

- A. III only.
- B. I and II only.
- C. I, II, and IV only.
- D. I, II, III, and IV.

**Answer:** C

**QUESTION:** 212

The main reason to establish internal controls in an organization is to

- A. Encourage compliance with policies and procedures.

- B. Safeguard the resources of the organization.
- C. Ensure the accuracy, reliability, and timeliness of information.
- D. Provide reasonable assurance on the achievement of objectives.

**Answer:** D

**QUESTION:** 213

The top three sales representatives for a company consistently include non-allowable charges on their expense reports. Line management is reluctant to deny reimbursement of the charges for fear of losing the sales representatives. This situation has the greatest negative impact on which of the following internal control components?

- A. Monitoring.
- B. Control environment.
- C. Information and communication.
- D. Control activities.

**Answer:** B

**QUESTION:** 214

According to the International Professional Practices Framework, risk is

- I. Defined as the negative effect of events that are expected to occur.
- II. Measured in terms of consequences.
- III. Measured in terms of likelihood.

- A. I only.
- B. I and II only.
- C. II and III only.
- D. I, II, and III.

**Answer:** C

**QUESTION:** 215

Which of the following should be incorporated in a risk management policy?

- I. Boundaries and limit structures.
- II. Requirements for reporting risk.
- III. Risk authorities.

- A. I and II only.
- B. I and III only.
- C. II and III only.
- D. I, II, and III.

**Answer: D**

**QUESTION: 216**

A high-volume retailer of consumer goods has used point-of-sale data to record sales and update inventory records for several years. When price changes are scheduled, corporate headquarters downloads a price change file to a computer server system at each store. Each store's assistant manager is responsible for checking the server for downloads and running the program that updates the store's price file at the authorized price update time. In comparison with having headquarters initiate the price update centrally, this approach to price updating will most likely

- A. Decrease the risk that customers will be undercharged consistently for sales items.
- B. Decrease the risk that item prices will sometimes be inaccurate.
- C. Increase the risk that customers will be undercharged consistently for sales items.
- D. Increase the risk that item prices will sometimes be inaccurate.**

**Answer: D**

**QUESTION: 217**

Which is the least effective form of risk management?

- A. Systems-based preventive control.
- B. People-based preventive control.
- C. Systems-based detective control.
- D. People-based detective control.**

**Answer: D**

**QUESTION: 218**

Which of the following describes a control weakness?

- A. Purchasing procedures are well designed and are followed unless otherwise directed by the purchasing supervisor.**
- B. Prenumbered blank purchase orders are secured within the purchasing department.
- C. Normal operational purchases fall in the range from \$500 to \$1,000 with two signatures required for purchases over \$1,000.
- D. The purchasing agent invests in a publicly traded mutual fund that lists the stock of one of the company's suppliers in its portfolio.

**Answer: A**

**QUESTION: 219**

An internal auditor is reviewing a new automated human resources system. The system contains a table of pay rates which are matched to the employee job classifications. The best control to ensure that the table is updated correctly for only valid pay changes would be to

- A. Limit access to the data table to management and line supervisors who have the authority to determine pay rates.
- B. Require a supervisor in the department, who does not have the ability to change the table, to compare the changes to a signed management authorization.
- C. Ensure that adequate edit and reasonableness checks are built into the automated system.
- D. Require that all pay changes be signed by the employee to verify that the change goes to a bona fide employee.

**Answer: B**

**QUESTION: 220**

A daily report which lists unsuccessful attempts to log on to a computer system is a

- A. Corrective control.
- B. Preventive control.
- C. Detective control.
- D. Compensating control.

**Answer: C**

**QUESTION: 221**

Which of the following internal controls is likely to prevent pollution from waste disposal before it occurs, rather than detect it after it occurs?

- A. Identification of large budget variances in disposal costs for hazardous chemicals.
- B. Restricted access to environmental department files.
- C. Formal on-the-job training program conducted by the environmental staff.
- D. Samples of water and solid waste taken daily with the results recorded in a log.

**Answer: C**

**QUESTION: 222**



An auditor for a large wholesaler is evaluating the controls over the approval and oversight of credit sales. Which of the following procedures would be a control weakness?

- A. The credit department is responsible for approving shipments to all customers.
- B. The finance committee of the board of directors periodically reviews credit standards.
- C. Customers who fail to meet credit requirements must pay cash for shipments upon delivery.
- D. The sales department is responsible for determining the credit ratings of customers.

**Answer:** D

**QUESTION:** 223

A dental insurance provider has implemented an electronic claim submission process and is concerned that dentists are submitting claims for services that were not provided. Which of the following control procedures would be most effective in preventing this type of fraud?

- A. Develop a program that identifies procedures performed on an individual which are either in excess of expectations based on the age of the insured or are similar to other procedures recently performed on the individual.
- B. Require all submitted claims to be followed by a signed statement by the dentist testifying to the fact that the claimed procedures were performed.
- C. Send confirmations to the dentists requesting them to confirm the exact nature of the claims submitted to the insurance provider.
- D. Develop an integrated test facility and submit false claims to verify that the system is detecting such claims on a consistent basis.

**Answer:** A

**QUESTION:** 224

Which of the following lists these audit steps in the correct chronological order?

- I. Create the engagement work program.
- II. Conduct the exit conference.
- III. Perform fieldwork.
- IV. Schedule the audit engagement.
- V. Issue a summary report of audit findings.

- A. I, IV, III, II, V.
- B. I, IV, II, III, V.
- C. IV, I, III, II, V.
- D. IV, III, I, V, II.

**Answer:** C

**QUESTION: 225**

To identify those components of a telecommunications system that present the greatest risk, an internal auditor should first

- A. Review the open systems interconnect network model.
- B. Identify the network operating costs.
- C. Determine the business purpose of the network.
- D. Map the network software and hardware products into their respective layers.

**Answer: C**

**QUESTION: 226**

An auditor plans to analyze customer satisfaction, including (1) customer complaints recorded by the customer service department during the last three months; (2) merchandise returned in the last three months; and (3) responses to a survey of customers who made purchases in the last three months. Which of the following statements regarding this audit approach is correct?

- A. Although useful, such an analysis does not address any risk factors.
- B. The survey would not consider customers who did not make purchases in the last three months.
- C. Steps 1 and 2 of the analysis are not necessary or cost-effective if the customer survey is comprehensive.
- D. Analysis of three months' activity would not evaluate customer satisfaction.

**Answer: B**

**QUESTION: 227**

When internal auditors provide consulting services, the scope of the engagement is primarily determined by

- A. Internal auditing standards.
- B. The audit engagement team.
- C. The engagement client.
- D. The internal audit activity's charter.

**Answer: C**

**QUESTION: 228**

An internal auditor is assigned to conduct an audit of security for a local area network (LAN) in the finance department of the organization. Investment decisions, including

the use of hedging strategies and financial derivatives, use data and financial models which run on the LAN. The LAN is also used to download data from the mainframe to assist in decisions. Which of the following should be considered **outside the scope** of this security audit engagement?

- A. Investigation of the physical security over access to the components of the LAN.
- B. The ability of the LAN application to identify data items at the field or record level and implement user access security at that level.
- C. Interviews with users to determine their assessment of the level of security in the system and the vulnerability of the system to compromise.
- D. The level of security of other LANs in the company which also utilize **sensitive data**.

**Answer:** D

**QUESTION:** 229

At the beginning of fieldwork in an audit of investments, an internal auditor noted that the interest rate had declined significantly since the engagement work program was created. The auditor should

- A. Proceed with the existing program since this was the original scope of work that was approved.
- B. Modify the audit program and proceed with the engagement.
- C. Consult with management to verify the interest rate change and proceed with the engagement.
- D. **Determine the effect of the interest rate change and whether the program should be modified.**

**Answer:** D

**QUESTION:** 230

Which of the following measurements could an auditor use in an audit of the efficiency of a motor vehicle inspection facility?

- A. The total number of cars approved.
- B. The ratio of cars rejected to total cars inspected.
- C. **The number of cars inspected per inspection agent.**
- D. The average amount of fees collected per cashier.

**Answer:** C

**QUESTION:** 231

A bakery chain has a statistical model that can be used to predict daily sales at individual stores based on a direct relationship to the cost of ingredients used and an

inverse relationship to rainy days. What conditions would an auditor look for as an indicator of employee theft of food from a specific store?

- A. On a rainy day, total sales are greater than expected when compared to the cost of ingredients used.
- B. On a sunny day, total sales are less than expected when compared to the cost of ingredients used.
- C. Both total sales and cost of ingredients used are greater than expected.
- D. Both total sales and cost of ingredients used are less than expected.

**Answer: B**

**QUESTION: 232**

Which of the following procedures would provide the best evidence of the effectiveness of a credit-granting function?

- A. Observe the process.
- B. Review the trend in receivables write-offs.
- C. Ask the credit manager about the effectiveness of the function.
- D. Check for evidence of credit approval on a sample of customer orders.

**Answer: B**

**QUESTION: 233**

An organization has developed a large database that tracks employees, employee benefits, payroll deductions, job classifications, and other similar information. In order to test whether data currently within the automated system are correct, an auditor should

- A. Use test data and determine whether all the data entered are captured correctly in the updated database.
- B. Select a sample of data to be entered for a few days and trace the data to the updated database to determine the correctness of the updates.
- C. Use generalized audit software to provide a printout of all employees with invalid job descriptions. Investigate the causes of the problems.
- D. Use generalized audit software to select a sample of employees from the database. Verify the data fields.

**Answer: D**

**QUESTION: 234**

Senior management at a financial institution has received allegations of fraud at its derivatives trading desk and has asked the internal audit activity to investigate and issue a report concerning the allegations. The internal audit activity has not yet developed sufficient **proficiency regarding** derivatives trading to conduct a thorough fraud investigation in this area. Which of the following courses of action should the chief audit executive (CAE) take to comply with the Standards?

- A. Engage the former head of the institution's derivatives trading desk to perform the investigation and submit a report with supporting documentation to the CAE.
- B. Request that senior management allow a delay of the fraud investigation until the internal audit activity's on-staff certified fraud examiner is able to obtain the appropriate training regarding the analysis of derivatives trading.
- C. Request that senior management exclude the internal audit activity from the investigation completely and instead contract with an external certified fraud examiner with derivatives experience to perform all aspects of the investigation and subsequent reporting.
- D. Contract with an **external certified fraud examiner with derivatives experience** to perform the investigation and subsequent reporting, with the chief audit executive approving the scope of the investigation and evaluating the adequacy of the work performed.

**Answer: D**

**QUESTION: 235**

According to the International Professional Practices Framework, internal auditors should possess which of the following competencies?

- I. Proficiency in applying internal auditing standards, procedures, and techniques.
- II. **Proficiency in accounting principles** and techniques.
- III. An understanding of management principles.
- IV. An understanding of the fundamentals of economics, commercial law, taxation, finance, and quantitative methods.

- A. I only.
- B. II only.
- C. I and III only.
- D. I, III, and IV only.

**Answer: D**

**QUESTION: 236**

Which of the following are acceptable resources for a chief audit executive to use when developing a staffing plan?

- I. Co-sourcing arrangements.
- II. Employees from other areas of the organization.

- III. The organization's external auditors.
- IV. The organization's audit committee members.

- A. I only.
- B. I and II only.
- C. II and IV only.
- D. I, II, and IV only.

**Answer: B**

**QUESTION: 237**

Which of the following would be a violation of the IIA Code of Ethics?

- A. Reporting information that could be damaging to the organization, at the request of a court of law.
- B. Including an issue in the final audit report after management has resolved the issue.
- C. Participating in an audit engagement for which the auditor does not have the necessary experience or training.
- D. Accepting a gift that is a commercial advertisement available to the public.

**Answer: C**

**QUESTION: 238**

Which of the following is not an appropriate objective for a quality assurance and improvement program?

- A. Continually monitor the internal audit activity's effectiveness.
- B. Assure conformance with the Standards and Code of Ethics.
- C. Perform an internal assessment at least once every five years.
- D. Communicate the results of quality assessments to the board.

**Answer: C**

**QUESTION: 239**

According to the International Professional Practices Framework, which of the following is true with respect to the different roles in the risk management process?

- I. Boards have an oversight role.
- II. Acceptance of residual risks can reside with the chief audit executive.
- III. The board can delegate the operation of the risk management framework to the management team.
- IV. The internal audit activity's role can range from having no responsibilities to managing and coordinating the process.

- A. I only.
- B. II and IV only.
- C. I, III, and IV only.
- D. I, II, III, and IV.

**Answer:** C

**QUESTION:** 240

Which of the following types of risk factors are used within risk models to establish the priority of internal audit engagements?

- I. Management competence.
- II. Quality of internal controls.
- III. Audit staff experience.
- IV. Regulatory requirements.

- A. II only.
- B. I, II, and III only.
- C. I, II, and IV only.
- D. I, III, and IV only.

**Answer:** C

**QUESTION:** 241

Which of the following is not an appropriate type of coordination between the internal audit activity and regulatory auditors?

- A. Regulatory auditors share their perspective on risk management, control, and governance with the internal auditors.
- B. Internal auditors perform fieldwork at the direction of the regulatory auditors.
- C. Internal auditors review copies of regulatory reports in planning related internal engagements.
- D. Regulatory and internal auditors exchange information about planned activities.

**Answer:** B

**QUESTION:** 242

An organization's accounts payable function improved its internal controls significantly after it received an unsatisfactory audit report. When planning a follow-up audit of the function, what level of detection risk should be expected if the audit and sampling procedures used are unchanged from the prior audit?

- A. Detection risk is lower because control risk is lower.
- B. Detection risk is lower because control risk is higher.
- C. Detection risk is higher because control risk is lower.

D. Detection risk is unchanged although control risk is lower.

**Answer:** D

**QUESTION:** 243

Which of the following is an appropriate role for the board in governance?

A. Preparing written organizational policies that relate to compliance with laws, regulations, ethics, and conflicts of interest.

B. Ensuring that financial statements are understandable, transparent, and reliable.

C. Assisting the internal audit activity in performing annual reviews of governance.

D. Working with the organization's attorneys to develop a strategy regarding current litigation, pending litigation, or regulatory proceedings governance.

**Answer:** B

**QUESTION:** 244

According to the International Professional Practices Framework, which of the following are allowable activities for an internal auditor?

I. Advocating the establishment of a risk management function.

II. Identifying and evaluating significant risk exposures during audit engagements.

III. Developing a risk response for the organization if there is no chief risk officer.

IV. Benchmarking risk management activities with other organizations.

V. Documenting risk mitigation strategies and techniques.

A. IV and V only.

B. I, II, and III only.

C. I, II, IV, and V only.

D. II, III, IV, and V only.

**Answer:** C

**QUESTION:** 245

According to the International Professional Practices Framework, which of the following should be stated in the internal audit charter?

I. Authorization for access to records.

II. The internal audit activity's position within the organization.

III. The relationship between the internal audit activity and the board.

IV. The scope of internal audit activities.

A. I and IV only.

B. II and III only.

C. I, II, and IV only.



D. I, II, III, and IV.

**Answer:** C

**QUESTION:** 246

Which of the following is not an appropriate role for internal auditors after a disaster occurs?

- A. Monitor the effectiveness of the recovery and control of operations.
- B. Correct deficiencies of the entity's business continuity plan.**
- C. Recommend future improvements to the entity's business continuity plan.
- D. Assist in the identification of lessons learned from the disaster and the recovery operations.

**Answer:** B

**QUESTION:** 247

Which component is the foundation of the COSO internal control framework?

- A. Risk assessment.
- B. Control environment.**
- C. Control activities.
- D. Monitoring.

**Answer:** B

**QUESTION:** 248

Which of the following best describes the underlying premise of the COSO enterprise risk management framework?

- A. Management should set objectives before assessing risk.
- B. Every entity exists to provide value for its stakeholders.**
- C. Policies are established to ensure that risk responses are performed effectively.
- D. Enterprise risk management can minimize the impact and likelihood of unanticipated events.

**Answer:** B

**QUESTION:** 249

Which of the following is an example of sharing risk?

- A. An organization redesigned a business process to change the risk pattern.
- B. An organization outsourced a portion of its services to a third-party service provider.
- C. An organization sold an unprofitable business unit to its competitor.
- D. In order to spread total risk, an organization used multiple vendors for critical materials.

**Answer:** B

**QUESTION:** 250

A records management system is an example of what type of control?

- A. Preventive.
- B. Detective.
- C. Corrective.
- D. Directive.

**Answer:** A

**QUESTION:** 251

Which of the following procedures is not a step that an auditor would perform when planning an audit of an organization?

- A. Obtaining detailed knowledge about the organization.
- B. Obtaining a management representation letter.
- C. Assessing the audit risk of the organization.
- D. Having discussions with the organization's management team.

**Answer:** B

**QUESTION:** 252

Which of the following risk assessment tools would best facilitate the matching of controls to risks?

- A. Control matrix.
- B. Internal control questionnaire.
- C. Control flowchart.
- D. Program evaluation and review technique (PERT) analysis.

**Answer:** A

**QUESTION:** 253

Which of the following factors should be considered when determining the staff requirements for an audit engagement?

- I. The internal audit activity's time constraints.
- II. The nature and complexity of the area to be audited.
- III. The period of time since the area was last audited.
- IV. The auditors' preference to audit the area.
- V. The results of a preliminary risk assessment of the activity under review.

- A. I and IV only.
- B. I, II, and V only.
- C. II, III, and V only.
- D. I, II, III, IV, and V.

**Answer:** B

**QUESTION: 1**

An auditor, assigned to review a complex computer system that had undergone a few system changes, obtained the prior flowchart used. Which of the following would be the most efficient way to document the changes?

- A. Create a new flowchart reflecting the system changes.
- B. Prepare a detailed narrative instead of a flowchart to describe the updated system.
- C. Add a detailed narrative to the prior flowchart to describe the changes to the system.
- D. Make the necessary adjustments on a copy of the prior flowchart and save as a new version.

**Answer: D**

**QUESTION: 2**

When interrogating an individual who is suspected of fraud, it is appropriate to

- A. Tell the individual that any information disclosed in the interrogation will not be disclosed outside of the company.
- B. Start the interview with questions to which the interviewer already knows the answer.
- C. Discontinue questioning once the individual has confessed to the fraud.
- D. Prepare a list of questions prior to the interrogation and strictly adhere to the list.

**Answer: B**

**QUESTION: 3**

Which of the following is typically not a reason for committing financial statement fraud?

- A. To dispel negative market perception.
- B. To disguise a duplicate payment to a vendor.
- C. To obtain more favorable terms on financing.
- D. To receive performance related bonuses.

**Answer: B**

**QUESTION: 4**

A company regularly invests excess short-term cash in trading securities. A reliable test of the valuation of those securities would be a

- A. Recalculation of investment carrying value using the equity method.

- B. Comparison of cost data with current market quotations.
- C. Confirmation of securities held by the broker.
- D. Calculation of premium or discount amortization.

**Answer:** B

**QUESTION: 5**

Which of the following sampling plans should an internal auditor use to estimate the number of units in a certain class of inventory without counting each item?

- A. Attributes sampling.
- B. Discovery sampling.
- C. Variables sampling.
- D. Stop or go sampling.

**Answer:** C

**QUESTION: 6**

Which of the following is an example of sampling risk?

- A. Overlooking material errors.
- B. Failing to analyze results properly.
- C. Checking invoices that are not representative of the population.
- D. Using audit procedures that are not appropriate for the given audit objective.

**Answer:** C

**QUESTION: 7**

Which of the following would constitute a violation of the IIA Code of Ethics?

- A. An internal auditor, who has recently joined the organization, has accepted an assignment to audit the electronics manufacturing division. The auditor previously served as senior auditor for the external audit of that division and has audited many electronics companies during the past two years.
- B. An internal auditor has accepted an assignment to audit the warehousing function six months from now. The auditor has no expertise in that area but has signed up for courses in warehousing that will be completed before the assignment begins.
- C. An internal auditor has no ambitions for promotion and has not engaged in training or other professional development activities during the last three years. The auditor's performance assessments indicate consistent quality of work.
- D. An internal auditor discovered an internal financial fraud during the year, and the financial statements were adjusted to properly reflect the loss associated with the fraud.

The auditor discussed the fraud with the external auditor during the external auditor's review of the working papers detailing the incident.

**Answer:** C

**QUESTION: 8**

A staff auditor, nearly finished with an audit engagement, discovers that the director of marketing has a gambling habit. The gambling issue is not directly related to the existing engagement and there is pressure to complete the current engagement. The auditor notes the problem and forwards the information to the chief audit executive but performs no further followup. The auditor's actions would

- I. Be in violation of the IIA Code of Ethics for withholding meaningful information.
- II. Be in violation of the Standards because the auditor did not properly follow up on a red flag that might indicate the existence of fraud.
- III. Not be in violation of either the IIA Code of Ethics or Standards.

- A. I only.
- B. II only.
- C. III only.
- D. I and II only.

**Answer:** C

**QUESTION: 9**

A code of ethics within the internal auditing profession is necessary in order to

- A. Reduce the likelihood that members of the profession will be sued for substandard work.
- B. Ensure that all members of the profession perform at approximately the same level of competence.
- C. Provide guidance to internal auditors in their service to others.
- D. Require members of the profession to exhibit loyalty in all matters pertaining to the affairs of their organization.

**Answer:** C

**QUESTION: 10**

An investment portfolio manager has the authority to use financial derivatives to hedge transactions but is not supposed to take speculative positions. However, the manager launches a scheme which includes

- (1) taking a position larger than required by the hedge;
- (2) putting the speculative gains in a suspense account; and

(3) transferring the funds to a nonexistent broker and from there to a personal account. Which of the following audit procedures would be least effective in detecting this fraud?

- A. Select a sample of individual trades and examine to determine whether the trades violate the authorization limit for the manager.
- B. Select a sample of individual trades and determine the exact matching of the hedge. Schedule and investigate all differences.
- C. Select a sample of all debits to the suspense account and examine their disposition.
- D. Select a sample of fund transfers to brokers and determine if the brokers are on the authorized list for company transactions.

**Answer:** A

**QUESTION: 11**

Confirmation would be most effective in addressing the existence assertion for

- A. The addition of a milling machine to a machine shop.
- B. Sales of merchandise during the regular course of business.
- C. Inventory held on consignment.
- D. The granting of a patent for a special process developed by the organization.

**Answer:** C

**QUESTION: 12**

Which of the following examples of audit evidence is the most persuasive?

- A. Real estate deeds, which were properly recorded with a government agency.
- B. Canceled checks written by the treasurer and returned from a bank.
- C. Time cards for employees, which are stored by a manager.
- D. Vendor invoices filed by the accounting department.

**Answer:** A

**QUESTION: 13**

During an operational audit of a chain of pizza delivery stores, an auditor determined that cold pizzas were causing customer dissatisfaction. A review of oven calibration records for the last six months revealed that adjustments were made on over 40 percent of the ovens. Based on this, the auditor

- A. Has enough evidence to conclude that improperly functioning ovens are the cause.
- B. Needs to conduct further inquiries and reviews to determine the impact of the oven variations on the pizza temperature.
- C. Has enough evidence to recommend the replacement of some of the ovens.
- D. Must search for another cause since approximately 60 percent of the ovens did not require adjustment.

**Answer:** B

**QUESTION: 14**

An auditor decides to vouch a sample of ledger entries back to their original documentation. In terms of whether all transactions had been recorded, this test would be

- A. Relevant to the completeness objective.
- B. Irrelevant to the completeness objective.
- C. A more timely test of completeness than evidence from interviews.
- D. A more biased test of completeness than evidence from interviews.

**Answer:** B

**QUESTION: 15**

An internal auditor for a financial institution has just completed an audit of loan processing. Of the 81 loans approved by the loan committee, the auditor found seven loans which exceeded the approved amount. Which of the following actions would be inappropriate on the part of the auditor?

- A. Examine the seven loans to determine if there is a pattern. Summarize amounts and include in the engagement final communication.
- B. Report the amounts to the loan committee and leave it up to them to correct. Take no further followup action at this time and do not include the items in the engagement final communication.
- C. Follow up with the appropriate vice president and include the vice president's acknowledgment of the situation in the engagement final communication.
- D. Determine the amount of the differences and make an assessment as to whether the dollar differences are material. If the amounts are not material, not in violation of government regulations, and can be rationally explained, omit the observation from the engagement final communication.



**Answer: B**

**QUESTION: 16**

The following is an excerpt from an audit engagement workpaper A Company Accounts Receivable Date Objective To determine if the computer system is correctly recording all accounts receivable transactions. Procedures Judgmental selection of a sample of all accounts receivable balances greater than \$50,000 for positive confirmation of balances. Conclusion Based on the results of testing wherein all but three confirmations were returned, the accounts receivable balance is fairly presented in all material respects. Which of the following is true regarding the workpaper?

- A. It is not appropriate to judgmentally select a sample when testing accounts receivable.
- B. A conclusion should be reached only for the results of overall testing, not for individual procedures.
- C. The audit procedures used are not consistent with the audit objective.
- D. The format of the workpaper does not conform to the standard format for workpapers.

**Answer: C**

**QUESTION: 17**

The efficiency of internal audit operations is best enhanced if workpaper standards

- A. Permit the extent of documentation to vary according to engagement objectives.
- B. Require supervisors to initial and date each workpaper that they review.
- C. Allow access to workpapers by external parties if approved by senior management or the audit committee.
- D. Mandate the workpaper retention period.

**Answer: A**

**QUESTION: 18**

Which of the following represents appropriate evidence of supervisory review of engagement workpapers?

- I. A supervisor's initials on each workpaper.
- II. An engagement workpaper review checklist.
- III. A memorandum specifying the nature, extent, and results of the supervisory review of workpapers.
- IV. Performance appraisals that assess the quality of workpapers prepared by auditors.

- A. II and IV only.
- B. I, II, and III only.
- C. I, III, and IV only.
- D. I, II, III, and IV.

**Answer:** B

**QUESTION:** 19

Which of the following conclusions would be appropriate for a beginning auditor performing an audit of a payroll department?

- A. Employee taxes have been deducted at the correct rates, and the taxes have been forwarded to the appropriate government agency.
- B. Although there is insufficient segregation of duties, the impact is mitigated by compensating controls.
- C. The payroll computer system should be replaced.
- D. The payroll department staff has the appropriate level of skills.

**Answer:** A

**QUESTION:** 20

A governmental auditor was assigned to determine reasons why the students in one region scored significantly higher on education evaluation tests than did the students in another region. Previous research showed that there is a direct correlation between public financial support and student results. Which of the following is most likely to explain the difference in the regional results?

- A. The more successful region spends 30 percent more money on education than does the other region.
- B. A higher percentage of the general tax fund is spent on education in the more successful region than in the other region.
- C. The more successful region spends more money per student on education than does the other region.
- D. The more successful region has increased educational spending by an average of 10 percent each year for the last three years, whereas the other region's increase averaged only three percent.

**Answer:** C

**QUESTION: 21**

Which of the following is not relevant when developing recommendations for inclusion in audit reports?

- A. Feasibility.
- B. Cost of implementation.
- C. Underlying causes.
- D. Timing of followup.

**Answer: D**

**QUESTION: 22**

Recommendations should be included in the audit report in order to

- A. Provide management with options for addressing audit findings.
- B. Ensure that audit findings are resolved in the manner suggested by the auditor.
- C. Minimize the amount of time required to correct audit findings.
- D. Ensure that audit findings are addressed by management.

**Answer: A**

**QUESTION: 23**

A chief audit executive has noticed that staff auditors are presenting more oral reports to supplement written reports. The best reason for the increased use of oral reports is that they

- A. Reduce the amount of testing required to support audit findings.
- B. Can be delivered in an informal manner without preparation.
- C. Can be prepared using a flexible format and reduce the information included in the written report.
- D. Permit auditors to counter arguments and provide additional information that the audience may require.

**Answer: D**

**QUESTION: 24**

Which of the following best defines an audit opinion?

- A. A summary of the significant audit observations and recommendations.
- B. An auditor's evaluation of the effects of the observations and recommendations on the activities reviewed.
- C. A conclusion which must be included in the audit report.
- D. A recommendation for corrective action.

**Answer:** B

**QUESTION: 25**

According to the International Professional Practices Framework, which of the following statements is correct regarding the communication of audit results?

- I. Summary reports may be issued separately from or in conjunction with the final report.
- II. Interim reports may be written or oral.
- III. Detailed reports should always be issued to the audit committee.
- IV. Interim reports should be used to communicate information which requires immediate attention.

- A. I and III only.
- B. II and IV only.
- C. I, II, and IV only.
- D. I, II, III, and IV.

**Answer:** C

**QUESTION: 26**

Once an audit report is drafted, the auditor's supervisor should review it primarily to ensure that all

- A. Statements are supported and can be authenticated.
- B. Recommendations for corrective action are clear.
- C. Processes within the audited area were reviewed.
- D. Sample sizes appear appropriate for any issues found.

**Answer:** A

**QUESTION: 27**

Which of the following is the best approach for obtaining feedback from engagement clients regarding the quality of internal audit work?

- A. Ask questions during the exit interviews and send copies of the documented responses to the clients.
- B. Call engagement clients after the exit interviews and send copies of the documented responses to the clients.
- C. Distribute questionnaires to selected engagement clients shortly before preparing the internal audit annual activity report.
- D. Provide questionnaires to engagement clients at the beginning of each engagement and request that the clients complete and return them after the engagements.

**Answer:** D

**QUESTION: 28**

After issuance of the engagement final communication for an audit of an organization's accounts payable function, which of the following should be sent satisfaction surveys?

- I. Manager of disbursements.
- II. Controller.
- III. Chief operating officer.
- IV. Audit committee members.

- A. I only.
- B. I and II only.
- C. II and III only.
- D. II, III, and IV only.

**Answer:** B

**QUESTION: 29**

What is the most likely source of information for a detailed schedule of a company's insurance policies in force?

- A. Original journal entries found in the cash disbursements journal, along with supporting checks processed by the bank.
- B. Policies and procedures governing insurance coverage.
- C. The current fiscal year's budget for insurance, together with the beginning balance of the prepaid insurance account.
- D. The files containing insurance policies with various carriers.

**Answer:** D

**QUESTION:** 30

Which of the following is a responsibility of the internal auditor once a fraud investigation has been concluded?

- A. Ascertain the extent to which fraud has been perpetrated.
- B. Notify the appropriate regulatory authorities regarding the outcome of the investigation.
- C. Determine if controls need to be implemented or strengthened to reduce future vulnerability.
- D. Implement controls to prevent future occurrences.

**Answer:** C

**QUESTION:** 31

Which of the following is the most appropriate step for the chief audit executive to take in order to avoid defamation of character of the principal suspect in a fraud investigation?

- A. Restrict the use of potentially damaging words to privileged reports or discussions.
- B. Label all workpapers, reports, and correspondence of the internal audit activity as private.
- C. Restrict discussions of the fraud to members of management who express an interest in the investigation.
- D. Destroy all investigation workpapers and reports if the fraud cannot be proven.

**Answer:** A

**QUESTION:** 32

What decision-making approach should a facilitator initiate if a group addresses an unfamiliar situation during a control self-assessment session?

- A. Spontaneous agreement.
- B. Consensus building.
- C. Majority voting.
- D. Compromise.

**Answer:** B

**QUESTION: 33**

A trucking company contracted a third party to construct a new vehicle maintenance facility. One of the trucking company's auditors was assigned to look for contractor overcharges. After reviewing the contract, the auditor recommended that an audit of the construction contract not be performed. What is the most likely reason for the auditor's recommendation?

- A. The contract did not include a right to audit clause.
- B. The contractor was engaged on a fixed price basis.
- C. The contractor's billing system included comprehensive edit routines to detect overbilling.
- D. The trucking company's accounts payable system compared amounts billed with contract terms to detect potential overcharges.

**Answer: B**

**QUESTION: 34**

A chief audit executive agrees to conduct an engagement that will focus on customers' perceptions of the quality of the organization's products and services. Which of the following issues should be addressed first?

- A. Cost effectiveness.
- B. Quality control.
- C. Customer complaints.
- D. Supplier deliveries.

**Answer: C**

**QUESTION: 35**

An internal auditor is concerned that a division's management may have shipped poor quality merchandise in order to inflate sales and thereby boost the division manager's bonus. Furthermore, the auditor suspects that returned goods are being shipped to other customers as new products before defects are fully corrected. Which of the following audit procedures would be least effective in determining whether such shipments took place?

- A. Examine credit memos issued after year end for goods shipped before year end.
- B. Physically observe the shipping and receiving area for evidence of returned goods.
- C. Interview customer service representatives regarding unusual numbers of customer

complaints.

D. Require the division to take a complete physical inventory at year end, and observe the taking of the inventory.

**Answer:** D

**QUESTION:** 36

One of the audit objectives for a manufacturing company is to verify that all rework is reviewed by the production engineer. Which of the following audit procedures would provide the best evidence for meeting this objective?

- A. Trace a sample of entries in the rework log to remedial action taken.
- B. Trace a sample of rework orders to entries in the rework log.
- C. Trace a sample of entries in the review log to rework orders.
- D. Trace a sample of rework orders to entries in the review log.

**Answer:** D

**QUESTION:** 37

As part of a preliminary survey of the purchasing function, an auditor read the department's policies and procedures manual. The auditor concluded that the manual described the processing steps well and contained an appropriate internal control design. The next engagement objective was to determine the operating effectiveness of internal controls. Which procedure would be most appropriate in meeting this objective?

- A. Prepare a flowchart.
- B. Prepare a system narrative.
- C. Perform a test of controls.
- D. Perform a substantive test.

**Answer:** C

**QUESTION:** 38

Which of the following would be the most effective method to prevent installation of new equipment that does not meet environmental permit requirements, or to prevent modification of current processes in such a way that they no longer meet permit requirements?



- A. Require that the environmental compliance department perform regular inspections of the manufacturing facility to identify new equipment or process modifications in progress.
- B. Rely on annual inspections by various regulatory agencies to identify equipment or processes that require a permit.
- C. Require that the staff of the environmental compliance department attend monthly safety meetings in different parts of the facility so that they can hear directly from the workers about any changes.
- D. Include the environmental compliance department in the review of proposed process changes and equipment purchases affecting permit requirements.

**Answer:** D

**QUESTION:** 39

An internal auditor found that the cost of some material installed on capital projects had been transferred to the inventory account because the capital budget had been exceeded. Which of the following would be an appropriate technique for the auditor to use to determine the extent of the problem?

- A. Identify variances between amounts capitalized each month and the capital budget.
- B. Analyze a sample of capital transactions each quarter to detect instances in which installed material was transferred to inventory.
- C. Review all journal entries that transferred costs from capital to inventory accounts.
- D. Compare inventory receipts with debits to the inventory account and investigate discrepancies.

**Answer:** C

**QUESTION:** 40

Which of the following audit steps would be most effective to review proper recording of and accountability over physical assets?

- I. Physically inspect all assets on the organization's property.
- II. Select a sample department and physically inspect assets in the department.
- III. Select a sample from the organization's records of physical assets and physically locate each asset.
- IV. Identify assets at a sample of locations and trace to the organization's records.

- A. I only.
- B. I and IV only.
- C. II and III only.

D. III and IV only.

**Answer:** D

**QUESTION:** 41

An audit of an organization's systems development life cycle (SDLC) found that detailed internal control procedures for mission critical business systems were not developed until the systems were implemented. When reporting this finding, the auditor should recommend the development of such procedures during which SDLC phase?

- A. Investigation.
- B. Design.
- C. Development.
- D. Implementation.

**Answer:** B

**QUESTION:** 42

In evaluating threats to an organization's network communication system, which of the following transmission media would an auditor recommend as most reliable and effective in thwarting intruders?

- A. Optical fiber cable.
- B. Satellite microwave.
- C. Radio frequency.
- D. Infrared.

**Answer:** A

**QUESTION:** 43

Which of the following would be the most appropriate starting point in a compliance evaluation of software licensing requirements for an organization with more than 15,000 computer workstations?

- A. Determine if software installation is controlled centrally or distributed throughout the organization.

- B. Determine what software packages have been installed on the organization's computers and the number of each package installed.
- C. Determine how many copies of each software package have been purchased by the organization.
- D. Determine what mechanisms have been installed for monitoring software usage.

**Answer:** A

**QUESTION:** 44

The internal audit activity's key responsibility for information security is to

- A. Identify technical aspects, risks, processes, and transactions to be examined.
- B. Determine the scope and degree of testing to achieve engagement objectives.
- C. Periodically assess information security practices.
- D. Document engagement procedures.

**Answer:** C

**QUESTION:** 45

In forming a team to investigate an organization's potential adoption of an activity based costing system, the best reason to include an internal auditor on the team would be the auditor's knowledge of

- A. Activities and cost drivers.
- B. Information processing procedures.
- C. Current product cost structures.
- D. Internal control alternatives.

**Answer:** D

**QUESTION:** 46

The scope of a consulting engagement performed by internal auditors should

- A. Be sufficient to address the objectives agreed upon with the client.
- B. Exclude areas that might be the subject of subsequent assurance engagements.
- C. Be limited to activities within the current operating period.
- D. Be preapproved in conjunction with the annual plan of consulting engagements.

**Answer:** A

**QUESTION:** 47

The scope of a business process review primarily involves

- A. Appraising the environment and comparing against established criteria.
- B. Assessing the organization's system of internal controls.
- C. Reviewing routine financial information and assessing the appropriateness of various accounting treatments.
- D. Evaluating organizational and departmental structures, including assessments of transaction flows.

**Answer:** D

**QUESTION:** 48

A company's cellular phone costs vary significantly by sales representative and by month. Which of the following would be the most appropriate approach for a consulting project concerning this issue?

- A. Control self-assessment involving sales representatives.
- B. Benchmarking with other cellular phone users.
- C. Business process review of cellular phone needs.
- D. Performance measurement and design of the budgeting process.

**Answer:** C

**QUESTION:** 49

Which of the following activities would be performed during a benchmarking consulting engagement?

- I. Collect data relevant to the benchmarking process.
- II. Review all business processes.
- III. Define critical success factors.
- IV. Identify performance gaps.

- A. I and III only.
- B. II and IV only.
- C. I, II, and III only.

D. I, III, and IV only.

**Answer:** D

**QUESTION: 50**

The internal audit activity can be involved with systems development continuously, immediately prior to implementation, after implementation, or not at all. An advantage of continuous internal audit involvement compared to the other types of involvement is that

- A. The cost of audit involvement can be minimized.
- B. There are clearly defined points at which to issue audit comments.
- C. Redesign costs can be minimized.
- D. The threat of lack of audit independence can be minimized.

**Answer:** C

**QUESTION: 51**

A bank is developing an integrated customer information system. The type of audit involvement that would most likely help avoid implementation of a system that does not cover all types of accounts would be

- A. A design review.
- B. An application control review.
- C. A source code review.
- D. An access control review.

**Answer:** A

**QUESTION: 52**

Which of the following potential performance measures should an auditor recommend excluding from a performance scorecard?

- A. Number of employees.
- B. Market share.
- C. Number of customer complaints.
- D. Training dollars per employee.

**Answer: A**

**QUESTION: 53**

An audit of a company's accounts payable found that the individuals responsible for maintaining the vendor master file could also enter vendor invoices into the accounts payable system. During the exit conference, management agreed to correct this problem. When performing a follow-up engagement of accounts payable, the auditor should expect to find that management has

- A. Transferred the individuals who maintained the vendor master file to another department to ensure that responsibilities are appropriately segregated.
- B. Compared the vendor and employee master files to determine if any unauthorized vendors have been added to the vendor master file.
- C. Changed the access control system to prevent employees from both entering invoices and approving payments.
- D. Modified the accounts payable system to prevent individuals who maintain the vendor master file from entering invoices.

**Answer: D**

**QUESTION: 54**

An audit of an organization's claims department determined that a large number of duplicate payments had been issued due to problems in the claims processing system. During the exit conference, the vice president of the claims department informed the auditors that attempts to recover the duplicate payments would be initiated immediately and that the claims processing system would be enhanced within six months to correct the problems. Based on this response, the chief audit executive should

- A. Adjust the scope of the next regularly scheduled audit to assess controls within the claims processing system.
- B. Discuss the findings with the audit committee and ask the committee to determine the appropriate followup action.
- C. Schedule a followup engagement within six months to assess the status of corrective action.
- D. Monitor the status of corrective action and schedule a followup engagement when appropriate.

**Answer: D**

**QUESTION: 55**

What is the primary factor that determines the depth and breadth of audit followup?

- A. The engagement client's written response to the audit findings.
- B. The auditor's assessment of risk associated with the audit findings.
- C. The auditor's assessment of personnel responsible for correcting audit findings.
- D. The availability of audit personnel and financial resources.

**Answer: B**

**QUESTION: 56**

An audit of customer accounts receivable found that outstanding receivables as a percentage of revenue had increased significantly during the past two years. The increase was attributed to the extension of credit, at the urging of the marketing department, to a number of companies that were not creditworthy. Which of the following would be least useful in monitoring the disposition of this finding?

- A. Responses from the manager of accounts receivable regarding collection of outstanding receivables.
- B. Periodic updates from the controller regarding the status of corrective actions.
- C. Information from the credit and marketing personnel assigned the responsibility for reevaluating credit policies.
- D. Updates from the information technology division regarding implementation of a new accounts receivable system.

**Answer: D**

**QUESTION: 57**

Given the scarcity of internal audit resources, a chief audit executive (CAE) decided not to schedule a followup of audit recommendations when developing engagement work schedules. Does the CAE's decision violate the Standards?

- A. No, because the Standards do not specify whether followup is needed.
- B. No, because when there is evidence of sufficient motivation by the client, there is no need for followup action.
- C. Yes, because scarcity of resources is not a sufficient reason to omit followup action.
- D. Yes, because the Standards require the auditors to determine whether the client has appropriately implemented all of the auditor's recommendations.

**Answer:** C

**QUESTION:** 58

At the conclusion of an audit of an organization's treasury department, a report was issued to the treasurer, chief financial officer, president, and board. Because of the sensitivity of some findings, a followup review was performed. The auditor should provide the report of followup findings to the

- I. Treasurer.
- II. Chief financial officer.
- III. President.
- IV. Board.

- A. I and II only.
- B. III and IV only.
- C. I, II, and III only.
- D. I, II, III, and IV.

**Answer:** D

**QUESTION:** 59

Which of the following conditions is the strongest indicator of possible fraud?

- A. An assistant treasurer who refuses to take vacations.
- B. Independent reconciliations of subsidiary to general ledgers that are not always completed on a timely basis.
- C. A condition of excess manufacturing waste material.
- D. A manager who is often over budget at the end of a reporting period.

**Answer:** A

**QUESTION:** 60

Which sampling plan requires no additional sampling once the first error is found?

- A. Stratified sampling.
- B. Attributes sampling.
- C. Stop or go sampling.
- D. Discovery sampling.



**Answer:** D

**QUESTION:** 61

Questions used to interrogate individuals suspected of fraud should

- A. Adhere to a predetermined order.
- B. Cover more than one subject or topic.
- C. Move from general to specific.
- D. Direct the individual to a desired answer.

**Answer:** C

**QUESTION:** 62

An auditor for a major retail company suspects that inventory fraud is occurring at three stores which have high costs of goods sold. Which of the following audit activities would provide the most persuasive evidence that fraud is occurring?

- A. Use an integrated test facility (ITF) to compare individual sales transactions with test transactions submitted through the ITF and investigate all differences.
- B. Interview the three individual store managers to determine if their explanations about the observed differences are the same, and then compare their explanations to that of the section manager.
- C. Schedule a surprise inventory audit to include a physical inventory and investigate areas of inventory shrinkage.
- D. Select a sample of individual store prices and compare them with the sales entered on the cash register for the same items.

**Answer:** C

**QUESTION:** 63

Insurance companies often receive electronic hospitalization claims directly from hospitals. Which of the following control procedures would be most effective in detecting fraud in such an environment?

- A. Use integrated test facilities to test the accuracy of processing in a manner that is transparent to data processing.

- B. Develop monitoring programs to identify unusual types of claims or an unusual number of claims by demographic class for investigation by the claims department.
- C. Use generalized audit software to match the claimant identification number with a master list of valid policyholders.
- D. Develop batch controls over all items received from a particular hospital and process those claims in batches.

**Answer:** B

**QUESTION:** 64

Which of the following might alert an auditor to the possibility of fraud in a division?

- I. The division is not scheduled for an external audit this year.
- II. Sales have increased by 10 percent.
- III. A significant portion of management's compensation is directly tied to reported net income of the division.

- A. I only.
- B. III only.
- C. I and II only.
- D. I, II, and III.

**Answer:** B

**QUESTION:** 65

A manager of one of a retailer's several retail outlets is stealing cash from cash sales, recording the sales as accounts receivable, and subsequently writing off the fictitious accounts receivable as bad debts. Which of the following comparisons would be most effective in signaling the possibility of such a fraud?

- A. Bad debt expense as a percentage of sales, compared to that of the other outlets.
- B. Bad debt expense as a percentage of sales, compared to that of previous years.
- C. Percentage of past due accounts receivable, compared to that of the other outlets.
- D. Percentage of past due accounts receivable, compared to that of previous years.

**Answer:** A

**QUESTION:** 66

One of the best ways for the board of an organization to deter fraudulent financial reporting is to

- A. Require board members to have current training and experience in financial accounting standards.
- B. Only appoint audit committee members with an understanding of financial accounting and reporting.
- C. Publish and monitor a code of conduct that creates a culture of honesty and high ethical values at all levels.
- D. Request that the external auditors review and report on the possibility of this type of fraud at each of their audits.

**Answer:** C

**QUESTION:** 67

In a sampling application, the group of items about which the auditor wants to estimate some characteristic is called the

- A. Population.
- B. Attribute of interest.
- C. Sample.
- D. Sampling unit.

**Answer:** A

**QUESTION:** 68

Increasing the desired precision from \$1,000 to \$2,000 would have what effect on the required size of a sample?

- A. It would increase the sample size.
- B. It would decrease the sample size.
- C. It would have no effect on the sample size.
- D. The effect on the sample size is not determinable.

**Answer:** B

**QUESTION:** 69

A recent survey indicated that residents of a small town take the train to a nearby city eight times per month, on average. The same survey showed that the number of train trips that a resident takes per month ( $y$ ) is determined by the number of days per month that the resident works in the nearby city ( $x$ ), according to the equation  $y = 2 + 2x$ . A person who never works in the nearby city is expected to take the train

- A. Zero times per month.
- B. Two times per month.
- C. Four times per month.
- D. Eight times per month.

**Answer:** B

**QUESTION:** 70

The internal auditor of a bank has developed a multiple regression model which has been used for a number of years to estimate the amount of interest income from commercial loans. During the current year, the auditor applies the model and discovers that the  $R^2$  value has decreased dramatically, but that the model otherwise seems to be working correctly. Which of the following conclusions is justified by the change?

- A. Changing to a cross sectional regression analysis should cause the  $R^2$  to increase.
- B. Regression analysis is no longer an appropriate technique to estimate interest income.
- C. Some new factors, not included in the model, are causing interest income to change.
- D. A linear regression analysis would increase the model's reliability.

**Answer:** C

**QUESTION:** 71

Five brand managers in a consumer products company met to determine how well certain promotions had performed. The data that they needed to analyze consisted of approximately 50 gigabytes of daily point of sale (POS) data for each month. The brand managers tried to download the POS data from the mainframe and import it into microcomputer spreadsheets for analysis. Their efforts were unsuccessful, most likely because of

- A. The complexity of the mainframe data structure and the large volume of data.
- B. The difficulty of establishing access privileges for each subset of the mainframe data.
- C. Inconsistencies in the mainframe data due to lack of integrity constraints on the data files.
- D. Error prone transmission links for downloading the data from the mainframe data files.

**Answer:** A

**QUESTION:** 72

An auditor is using an internal control questionnaire as part of a preliminary survey. Which of the following is the best reason for the auditor to interview management regarding the questionnaire responses?

- A. Interviews provide the opportunity to insert questions to probe promising areas.
- B. Interviews are the most efficient way to upgrade the information to the level of objective evidence.
- C. Interviewing is the least costly audit technique when a large amount of information is involved.
- D. Interviewing is the only audit procedure which does not require confirmation of the information that is obtained.

**Answer:** A

**QUESTION:** 73

Many questionnaires are made up of a series of different questions that use the same response categories (for example strongly agree, agree, neither, disagree, strongly disagree). Some designs will have different groups of respondents Answer: alternate versions of the questionnaire that present the questions in different orders and reverse the orientation of the endpoints of the scale (for example agree on the right and disagree on the left). The purpose of such questionnaire variations is to

- A. Eliminate intentional misrepresentations.
- B. Reduce the effects of pattern response tendencies.
- C. Test whether respondents are reading the questionnaire.
- D. Make it possible to get information about more than one population parameter using the same questions.

**Answer:** B

**QUESTION:** 74

A limitation of using ratio analysis in an audit engagement is that it

- A. Often uses financial information provided by management which has not been reviewed for reliability and validity.
- B. Is an expensive method of testing.
- C. Requires computer software in order to develop meaningful interpretations of data.
- D. Is useful only when comparisons can be made across other industries.

**Answer:** A

**QUESTION:** 75

If cost estimates in an economic order quantity (EOQ) model are varied to determine how much the changes affect the optimal EOQ, such analysis would be called a

- A. Forecasting model.
- B. Sensitivity analysis.
- C. Critical path analysis.
- D. Decision analysis.

**Answer:** B

**QUESTION:** 76

A company owns a machine that will produce 100 light switches in four hours. Due to increased demand, a second machine capable of producing 100 light switches in three hours has been added. Approximately how many hours will it take to produce 100 light switches using both machines working together?

- A. 7.0
- B. 3.5
- C. 1.7
- D. 0.58

**Answer:** C

**QUESTION:** 77

Which of the following are reasons to involve employees in the control self assessment process?

- I. Employees become more motivated to do their jobs correctly.
- II. Employees are objective about their jobs.
- III. Employees can provide an independent assessment of internal controls.

IV. Employees provide management with valuable information.

- A. I and II only.
- B. I and IV only.
- C. II and III only.
- D. III and IV only.

**Answer:** B

**QUESTION:** 78

Which of the following would provide the greatest assurance of the accuracy of a computer program's computation of freight charges for catalog sales?

- A. Use discovery sampling, selecting transactions from invoices which should have freight charges added to them.
- B. Use either test data or parallel simulation to test the computer application.
- C. Use difference estimation, selecting transactions from invoices which should have freight charges added to them.
- D. Use generalized audit software to select a monetary unit sample of invoices that have been billed to customers.

**Answer:** B

**QUESTION:** 79

An auditor has been assigned to audit the computerized inventory records as part of an audit of production activities. It would be most appropriate to use a generalized audit software package to

- A. Assess the processing accuracy of the update program in posting transactions to the inventory master file.
- B. Evaluate the adequacy of internal controls embedded in the computer program.
- C. Substantiate the data entries from terminals located in the production department.
- D. Verify the accuracy of the extensions and summations of inventory balances.

**Answer:** D

**QUESTION: 80**

Which of the following methods would an auditor most likely use to document a complex sales order process?

- A. Develop a horizontal flowchart, with supporting documentation for key control points.
- B. Create a critical path method chart, noting the processes involved for each step.
- C. Perform a process review, assigning time and cost to each step of the process to develop a hierarchy flowchart.
- D. Utilize a systems narrative, which can be updated during subsequent audits.

**Answer: A**

**QUESTION: 81**

An internal auditor for a large regional bank holding company was asked to serve on the board of directors of a local bank. The bank competes in many of the same markets as the bank holding company but focuses more on consumer financing than on business financing. In accepting this position, the auditor

- I. Violates the IIA Code of Ethics because serving on the board is in direct conflict with the best interests of the auditor's employer.
- II. Violates the IIA Code of Ethics because the information gained while serving on the board of directors of the local bank may influence recommendations regarding potential acquisitions.
- III. Does not violate the IIA Code of Ethics.

- A. I only
- B. II only
- C. III only
- D. I and II only

**Answer: D**

**QUESTION: 82**

When performing a followup review of an organization's billing function, which of the following would be appropriate?

- I. Consider followup measures performed by managers in the organization.
- II. Investigate payables problems that have emerged since completion of the audit.
- III. Assess the adequacy of corrective measures taken by management

- A. I and II only



- B. I and III only
- C. II and III only
- D. I, II, and III

**Answer:** B

**QUESTION:** 83

An auditor plans to query a vendor database to locate evidence of a fictitious vendor scheme. Which of the following would be likely to detect this type of fraud?

- I. Vendors that lack a phone number or an address
- II. Vendors that have a post office box as an address
- III. Vendors that have multiple addresses

- A. I only
- B. III only
- C. I and II only
- D. I, II, and III

**Answer:** C

**QUESTION:** 84

Which of the following techniques would be most effective in managing emotional issues that emerge during a control self assessment workshop?

- A. Allow the group to vent their emotions until they are ready to return to the agenda
- B. Acknowledge underlying emotions and then continue with the workshop
- C. Respectfully remind the group of the agenda that they agreed to pursue and continue with the workshop.
- D. Facilitate the discussion so that the emotions can be channeled into appropriate action plans.

**Answer:** D

**QUESTION:** 85

Which of the following is not an outcome of control self assessment (CSA)?

- A. Management and employees of business units become trained in risk assessment and management.
- B. Employees take ownership of the risks and control procedures in their business unit.
- C. The internal audit activity no longer needs to evaluate risks and control procedures for business units that have implemented CSA.
- D. Overall monitoring improves, and continuous improvement is possible.

**Answer:** C

**QUESTION:** 86

During a fraud investigation, an internal auditor finds that one of the suspects is the senior executive to whom fraudulent activities are to be reported. Would it be appropriate for the internal auditor to report interim findings directly to the audit committee without notifying the senior executive?

- A. Yes, because it is important to maintain confidentiality while obtaining evidence.
- B. Yes, because the audit committee should make all decisions regarding fraud investigations.
- C. No, because the auditor should report the findings directly to law enforcement officials.
- D. No, because all frauds are to be reported to the senior executive.

**Answer:** A

**QUESTION:** 87

Which of the following is correct with respect to interim communication during an audit engagement?

- I. Unsubstantiated information that warrants management's attention can be communicated, provided that its nature is disclosed.
- II. Audit recommendations should be reserved for the final audit report.
- III. Significant findings should be communicated immediately rather than waiting until completion of the engagement.

- A. I only.
- B. I and III only.
- C. II and III only.
- D. I, II, and III only.

**Answer:** B

**QUESTION: 88**

The use of probability proportional to size (PPS) sampling is not efficient if

- A. Bank accounts are being audited.
- B. Each item is of equal importance.
- C. The number of sampling units is large.
- D. Statistical inferences are to be made.

**Answer: B**

**QUESTION: 89**

Which of the following must be true when using regression analysis involving three variables?

- A. Two of the variables must have some relationship to each other, but the other can be unrelated.
- B. One of the variables must include financial information, and the other two must include nonfinancial information.
- C. All of the variables must have some relationship to each other.
- D. Two of the variables must include financial information, and the other must include nonfinancial information.

**Answer: C**

**QUESTION: 90**

Which of the following is an advantage of nonstatistical sampling over statistical sampling?

- A. Nonstatistical sampling provides a measure of the sufficiency of the evidence gathered.
- B. Nonstatistical sampling provides a more defensible expression of the test results.
- C. Nonstatistical sampling is simple to use with software.
- D. Nonstatistical sampling allows the auditor to apply subjective judgment.

**Answer: D**

**QUESTION: 91**

In an audit test designed to determine if fictitious employees are on the payroll, evidence that all timecards are approved by the employee's immediate supervisor would meet which of the following evidence tests?

- I. Sufficient.
- II. Competent.
- III. Relevant.

- A. I only.
- B. I and III only.
- C. II and III only.
- D. I, II, and III.

**Answer:** C

**QUESTION:** 92

Which of the following statements is **not true** regarding audit fieldwork?

- A. It takes place primarily during the preliminary survey stage.
- B. It focuses on causes, effects, or conditions.
- C. It involves systematic gathering of information.
- D. It is used to substantiate information provided during interviews.

**Answer:** A

**QUESTION:** 93

The purpose of a walk through of an audit client's processes is for an internal auditor to

- A. Confirm the completion of tasks.
- B. Assess the effectiveness of existing internal controls.
- C. Understand existing controls and processes.
- D. Determine the existence of fraud.

**Answer:** C

**QUESTION:** 94

A company has recently implemented an electronic commerce system for purchasing and billing, which relies heavily on electronic data interchange, electronic funds transfer, and

just in time manufacturing technology. If the system was properly implemented, an auditor would expect to see all of the following changes except

- A. Lower accounts receivable balances.
- B. Lower accounts payable balances.
- C. Increased cash flow and treasury balances.
- D. Increased inventory balances.

**Answer:** D

**QUESTION: 95**

While conducting a control self assessment project in an information technology division, an internal auditor asks managers to rate the severity of each identified risk and the strength of each related control. Which of the following represents the most significant disadvantage of this exercise?

- A. Budget hours expended will exceed any tangible benefits.
- B. Subsequent audits of the division may not be conducted.
- C. Management may omit important control weaknesses.
- D. The internal audit department will be viewed as responsible for controls.

**Answer:** C

**QUESTION: 96**

A followup review found that a significant internal control weakness had not been corrected. The chief audit executive (CAE) discussed this matter with senior management and was informed of management's willingness to accept the risk. The CAE should

- A. Do nothing further because management is responsible for deciding the appropriate action to be taken in response to reported audit findings and recommendations.
- B. Initiate a fraud investigation to determine if employees had taken advantage of the internal control weakness.
- C. Inform senior management that the weakness must be corrected and schedule another followup review.
- D. Assess the reasons that senior management decided to accept the risk and inform the board of senior management's decision.

**Answer:** D

**QUESTION: 97**

Which of the following fraudulent acts is not designed primarily to benefit the organization?

- A. Sale or assignment of fictitious assets.
- B. Improper payments such as bribes or kickbacks.
- C. Improper valuation of transactions.
- D. Acceptance of bribes or kickbacks.

**Answer: D**

**QUESTION: 98**

Time series forecasting models can include which of the following components?

- I. Trends.
- II. Seasonal variations.
- III. Cycles.

- A. I only.
- B. I and II only.
- C. II and III only.
- D. I, II, and III.

**Answer: D**

**QUESTION: 99**

As an audit technique, observation is

- I. Limited because individuals may react differently when being observed.
- II. More persuasive for the completeness assertion than it is for the existence assertion when testing financial statement balances.
- III. Effective in providing evidence on how the company's processes differ from those specified by written policies.

- A. I only.
- B. II only.
- C. I and III only.
- D. I, II, and III only.

**Answer:** C

**QUESTION:** 100

An internal auditor has been asked to provide a report to an external party for which internal audit services were provided. Which of the following should be considered prior to complying with the request?

- I. Need for a written agreement concerning the information to be reported.
- II. Limitations on the distribution or sharing of the information provided.
- III. Nature of the report, including conclusions, recommendations, and status of findings.
- IV. Appropriateness of revising or editing the report to make it more suitable for dissemination outside the organization.

- A. I and III only.
- B. II and IV only.
- C. I, II, and III only.
- D. I, II, III, and IV.

**Answer:** D

**QUESTION:** 101

Which of the following tests must an internal auditor perform in order to ensure that inbound electronic data interchange (EDI) transactions are received and translated accurately?

- I. Computerized tests to assess transaction reasonableness and validity.
- II. Review of log books to ensure that transactions are logged upon receipt.
- III. Edit checks to identify unusual transactions.
- IV. Verification of limitations on the authority of users to initiate specific EDI transactions.

- A. I and IV only.
- B. II and III only.
- C. I, II, and III only.
- D. I, II, III, and IV.

**Answer:** C

**QUESTION:** 102

An internal auditor downloaded all database records pertaining to payables, purchases, production, inventory, and receivables, and wrote a program to verify that All payables had an authorizing purchase order.

All production materials were legitimate inventory items.  
All receivables derived from production.  
What is the internal auditor testing?

- A. Referential integrity.
- B. Modeling consistency.
- C. Data redundancy.
- D. Concurrency control.

**Answer:** A

**QUESTION:** 103

An internal audit activity has just completed a fraud investigation involving the company's president. Before the audit report is issued, a front page article appears in a major newspaper alleging that the president has been using the organization's funds for personal purposes. The chief audit executive (CAE), who has enough information to confirm the allegations, is contacted by the newspaper to confirm the facts. Which of the following would be the best response by the CAE?

- A. Respond truthfully and fully since the CAE is in a position to confirm the facts.
- B. Direct the inquiry to the audit committee or the board of directors.
- C. Provide information "off the record" so that the article does not state who provided the information.
- D. Respond that the investigation is not complete.

**Answer:** B

**QUESTION:** 104

An auditor receives anonymous information that fraud is occurring in the operation being audited, but no details are given as to the type of fraud or the individuals involved. There are several areas in which fraud could occur. The auditor should

- A. Identify the area that has the greatest volume of transactions and design a sampling plan for substantive testing.
- B. Apply analytical procedures to areas that might be impacted by possible fraudulent activities.
- C. Interview employees to identify areas where the fraud could be occurring.
- D. Plan detailed tests of the areas that have the highest dollar amount of transactions.



**Answer: B**

**QUESTION: 105**

A production manager for a moderate sized manufacturing company began ordering excessive raw materials and had them delivered to a wholesale company that the manager was running as a separate business. The manager falsified receiving documents and approved the invoices for payment. Which of the following audit procedures would most likely detect this fraud?

- A. Select a sample of cash disbursements and compare to purchase orders, receiving reports, invoices, and check copies.
- B. Select a sample of cash disbursements and confirm the amount purchased, purchase price, and date of shipment with the vendors.
- C. Observe the receiving dock and count materials received; compare the counts to receiving reports completed by receiving personnel.
- D. Perform analytical tests, comparing production, materials purchased, and raw materials inventory levels; investigate any differences.

**Answer: D**

**QUESTION: 106**

During the course of a bank audit, an auditor discovers that one loan officer has approved loans to a number of related but separate organizations, in violation of regulatory policies. The loan officer indicated that it was an oversight and would not happen again. However, the auditor believes that the action may have been intentional because the loan officer is a relative of one of the primary owners of the corporate group that controls the related organizations. The auditor should

- A. Inform management of the conflict of interest and the violation of the regulatory requirements and suggest further investigation.
- B. Report the violation to the regulatory agency because it constitutes a significant breakdown of the bank's control structure.
- C. Not report the violation if the loan officer agrees to take corrective action.
- D. Expand the audit work to determine if there may be fraudulent activity on the part of the loan officer and report the findings to management when the followup investigation is complete.

**Answer: A**

**QUESTION: 107**

During the initial audit of a new billing system for a large telephone company, the internal auditors considered downloading several days' worth of transactions to a file for analysis using generalized audit software. The major deficiency of this approach is that

- A. There may not be enough data to detect problems that occur infrequently.
- B. Audit software is not designed to work effectively on this much data.
- C. The required audit techniques would be unfamiliar to the auditors.
- D. Performing the selection of transactions may interrupt processing too severely.

**Answer: A**

**QUESTION: 108**

During an audit of capital assets, an auditor tested the accuracy of recorded depreciation. The best evidence that an asset is still in service would result from a

- A. Review of fixed assets records for the asset.
- B. Comparison of the asset's depreciation schedule with its maintenance records.
- C. Comparison of the asset's depreciation schedule with its insurance appraisal.
- D. Review of depreciation policies and procedures for capital assets.

**Answer: B**

**QUESTION: 109**

In reviewing the appropriateness of the minimum quantity level of inventory established by a department, an auditor would be least likely to consider

- A. Stockout costs, including lost customers.
- B. Seasonal variations in forecasting inventory demand.
- C. Optimal order sizes determined by an economic order quantity model.
- D. The potential for obsolescence of inventory items.

**Answer: C**

**QUESTION: 110**

A film company determined that income level impacts the number of films that people watch per month, as shown by the graph below

- A. The graph indicates that
- B. A richer person always sees more films than a poorer person.
- C. The number of films seen per month is a linear function of income level.
- D. A 20 percent pay increase is more likely to increase film viewing at lower income levels than at higher income levels.
- E. A 20 percent pay increase is likely to increase film viewing by a constant amount regardless of income level.

**Answer:** C

**QUESTION:** 111

As a result of a recent discovery of false information on employment applications, an internal auditor has reviewed hiring procedures. Which of the following represents a weakness in the control system?

- I. Applicants are not required to have their signed applications legally authenticated.
- II. Applicants' educational information is not validated with the educational institution before employment is offered.
- III. Information related to applicants' long term work history is not validated before employment is offered.

- A. III only.
- B. I and II only.
- C. II and III only.
- D. I, II, and III.

**Answer:** C

**QUESTION:** 112

During an interview with a manager in a company's claims department, an auditor noted that the manager became nervous and changed the subject whenever the auditor raised questions about certain types of claims. The manager's answers were consistent with company policies and procedures. When documenting the interview, the auditor should

- A. Document the manager's answers, noting the nature of the nonverbal communication.
- B. Document the manager's answers but not the nonverbal communication because it is subjective and is not corroborated.
- C. Conclude that the nonverbal communication is persuasive and that sufficient evidence exists to begin a fraud investigation.

D. Disregard the interview entirely because the verbal and nonverbal communications were contradictory.

**Answer:** A

**QUESTION:** 113

According to the International Professional Practices Framework, all workpapers prepared by an internal auditor are the **property** of the

- A. Chief audit executive.
- B. Internal auditor.
- C. Organization.**
- D. Audit committee.

**Answer:** C

**QUESTION:** 114

An audit supervisor returned a workpaper to an auditor with a request to document the tickmarks used in testing. The supervisory review found errors in the area of workpaper

- A. Validity.
- B. Efficiency.
- C. Judgment.
- D. Completeness.

**Answer:** D

**QUESTION:** 115

According to the International Professional Practices Framework, which of the following is an appropriate reason for issuing an interim report?

- I. To keep management informed of audit progress when audit engagements extend over a long period of time.
- II. To provide an alternative to a final report for limited scope audit engagements.
- III. To communicate a change in engagement scope for the activity under review.

- A. I and II only.
- B. I and III only.

- C. II and III only.
- D. I, II, and III.

**Answer:** B

**QUESTION:** 116

A medium-sized municipality provides 8.5 billion gallons of water per year for 31,000 customers. The water meters are replaced at least every five years to ensure accurate billing. The department recently issued the following activity report

Activity

Month One

Month Two

Month Three

Actual 1st Quarter

1st Quarter Goal

Meters replaced

475

400

360

1,235

1,425

Leaks reported

100

100

85

285

Leaks repaired

100

100

85

285

100%

Based on the activity reported for leaks repaired during the first quarter, an internal auditor would conclude that

- A. The leak-repair program is adequately staffed.
- B. The operating standard should be changed.
- C. Deviations from the goal should be analyzed and corrected.
- D. Established operating standards are understood and are being met.

**Answer:** D

**QUESTION: 117**

A medium-sized municipality provides 8.5 billion gallons of water per year for 31,000 customers. The water meters are replaced at least every five years to ensure accurate billing. The department recently issued the following activity report

Activity

Month One

Month Two

Month Three

Actual 1st Quarter

1st Quarter Goal

Meters replaced

475

400

360

1,235

1,425

Leaks reported

100

100

85

285

Leaks repaired

100

100

85

285

100%

Based on the activity reported for the meter replacement program, an internal auditor would conclude that

- A. Established operating standards are understood and are being met.
- B. Any corrective action needed has probably been taken during the quarter.
- C. Deviations from the goal should be analyzed and corrected.
- D. Meters should be changed every three years.

**Answer: C**

**QUESTION: 118**

During the development of a purchasing system, an auditor reviewed the payment authorization program. Which of the following actions should the auditor recommend for a situation in which the quantity invoiced is greater than the quantity received?

- A. Issue an exception report.
- B. Pay the amount billed and adjust the inventory account for the difference.
- C. Return the invoice to the vendor for correction.
- D. Authorize payment of the full invoice, but maintain an open purchase order record for the missing goods.

**Answer:** A

**QUESTION:** 119

What is the primary reason for having audit management approve audit engagement reports?

- A. To ensure that client concerns are appropriately addressed.
- B. To confirm proper format, grammar, and punctuation.
- C. To verify that senior management supports the report's conclusions.
- D. To validate that report findings are substantiated.

**Answer:** D

**QUESTION:** 120

According to the Standards, internal audit reports should be distributed to those members of the organization who are able to ensure that audit results are given due consideration. For senior members of the organization, this requirement can usually be satisfied using

- A. Summary reports.
- B. Interim reports.
- C. Oral reports.
- D. Final written reports only.

**Answer:** A

**QUESTION:** 121

Which of the following would provide a chief audit executive with the most useful information on how the internal auditors interact with management during audit activities?

- A. Customer surveys.

- B. Interviews with auditors.
- C. Responses to the audit report.
- D. Workpaper narratives.

**Answer:** A

**QUESTION:** 122

In a client satisfaction survey for an internal audit engagement, client management should be asked to assess which of the following factors?

- I. Audit team's knowledge of the audited area.
- II. Usefulness of the audit results.
- III. Quality of management of the internal audit activity.
- IV. Clarity of the scope and objectives of the audit engagement.

- A. I and II only.
- B. II and IV only.
- C. I, II, and IV only.
- D. I, III, and IV only.

**Answer:** C

**QUESTION:** 123

Client satisfaction surveys provide the engagement client with an opportunity to

- A. Provide further information on the issues identified during the engagement.
- B. Respond to the internal audit report findings.
- C. Suggest ways to improve the audit process.
- D. Perform a self assessment to supplement the internal audit report findings.

**Answer:** C

**QUESTION:** 124

When interviewing an individual suspected of a fraud, the interviewer should

- A. Ensure the suspect's supervisor is present during the interview.
- B. Lock the door to deter interruptions.
- C. Pay attention to the wording choices of the suspect.



D. Ask if the suspect committed the fraud.

**Answer:** C

**QUESTION:** 125

If participants in a control self assessment workshop begin breaking their agreed upon ground rules, the facilitator should

- A. Ignore the behavior and continue the workshop.
- B. Allow them to continue briefly and then remind them of the ground rules.
- C. Have the participants modify the ground rules.
- D. Strictly enforce the ground rules.

**Answer:** B

**QUESTION:** 126

An auditor is scheduled to audit payroll controls for a company which has recently outsourced its processing to an information service bureau. What action should the auditor take, considering the outsourcing decision?

- A. Review the controls over payroll in both the company and the service bureau.
- B. Review only the company's controls over data sent to and received from the service bureau.
- C. Review only the controls over payments to the service bureau based on the contract.
- D. Cancel the engagement because the processing is being performed outside of the organization.

**Answer:** A

**QUESTION:** 127

An organization contracted a third party to construct a new facility that was estimated to cost \$25 million. Which of the following is the most pertinent reason for the organization to audit the contractor's records?

- A. The contract includes a right to audit clause.
- B. The contractor will be paid on a cost plus basis.
- C. The estimated cost is high.
- D. The contractor has subcontracted much of the work.

**Answer:** B

**QUESTION:** 128

When performing a quality audit engagement in a factory, an internal auditor should first review

- A. Comparisons of actual outputs to planned outputs.
- B. Levels of rework and scrap.
- C. Costs of materials purchased.
- D. Fulfillment of production quotas.

**Answer:** B

**QUESTION:** 129

An auditor evaluating excessive product rejection rates should investigate

- I. Communication between sales and production departments on sales returns.
- II. Volume of product sales year to date in comparison to prior year to date.
- III. Changes in credit ratings of customers versus sales to those customers.
- IV. Detailed product scrap accounts and accumulations.

- A. I and III only.
- B. I and IV only.
- C. II, III, and IV only.
- D. I, II, III, and IV.

**Answer:** B

**QUESTION:** 130

An internal audit activity is participating in the due diligence work for an acquisition that a company is considering. One engagement objective is to determine if the acquisition's accounts payable contain all outstanding liabilities. Which of the following audit procedures would not be relevant for this objective?

- A. Examine supporting documentation of subsequent (after period) cash disbursements and verify period of liability.

- B. Send confirmations, including zero balance accounts, to vendors with whom the company normally does business.
- C. Select a sample of accounts payable from the accounts payable list and verify the supporting receiving reports, purchase orders, and invoices.
- D. Trace receiving reports issued before the period end to the related vendor invoices and accounts payable list.

**Answer:** C

**QUESTION:** 131

A company has recently incurred significant cost overruns on one of its construction projects. Management suspects that these overruns were caused by the contractor improperly accounting for costs related to contract change orders. Which of the following procedures would be appropriate for testing this suspicion?

- I. Verify that the contractor has not charged change orders with costs that have already been billed to the original contract.
- II. Determine if the contractor has billed for original contract work that was canceled as a result of change orders.
- III. Verify that the change orders were properly approved by management.

- A. I only.
- B. III only.
- C. I and II only.
- D. I and III only.

**Answer:** C

**QUESTION:** 132

As part of an operational audit, an auditor compared records of current inventory with usage during the prior two year period and determined that the spare parts inventory was excessive. What step should the auditor perform first?

- A. Determine the effects of a stock-out on the organization's profitability.
- B. Determine whether a clear policy exists for setting inventory limits.
- C. Determine who approved the purchase orders for the spare parts.
- D. Determine whether purchases were properly recorded.

**Answer:** B

**QUESTION: 133**

Which of the following would provide the best audit evidence regarding the effectiveness of an applied research department?

- A. Develop a cost per product analysis for products developed over the past five years.
- B. Develop a report on revenue generated by or cost savings directly attributable to newly developed products.
- C. Compare research as a percentage of revenue between this company and all major competitors in the same industry.
- D. Compare the number of this year's new product developments to the number of new product developments for the past five years.

**Answer: B**

**QUESTION: 134**

A transportation department maintains its vehicle inventory and maintenance records in a database. Which of the following audit procedures is most appropriate for evaluating the accuracy of the database information?

- A. Verify a sample of the records extracted from the database with supporting documentation.
- B. Submit batches of test transactions through the current system and verify with expected results.
- C. Simulate normal processing by using test programs.
- D. Use program tracing to show how, and in what sequence, program instructions are processed in the system.

**Answer: A**

**QUESTION: 135**

During which of the following systems development stages would it be most useful for an internal auditor to be involved?

- A. Coding and testing.
- B. User acceptance and post implementation.
- C. Design and implementation.
- D. Testing and user acceptance.

**Answer:** C

**QUESTION:** 136

During an information security audit, an auditor discovers that the current disaster recovery plan was developed three years ago but never tested. There have been significant changes to information systems since the plan was developed. The auditor should

- A. Ask management to test the recovery plan immediately.
- B. Recommend that management and users update and test the recovery plan.
- C. Update the recovery plan for management as part of the review.
- D. Review the recovery plan and report weaknesses to management.

**Answer:** B

**QUESTION:** 137

Which of the following is used to identify and prioritize critical business applications to determine those that must be restored and the order of restoration in the event that a disaster impairs information systems processing?

- A. Contingent facility contract analysis.
- B. System backup analysis.
- C. Vendor supply agreement analysis.
- D. Risk analysis.

**Answer:** D

**QUESTION:** 138

During a systems development audit, software developers indicated that all programs were moved from the development environment to the production environment and then tested in the production environment. What should the auditor recommend?

- I. Implement a test environment to ensure that testing is not performed in the production environment.
- II. Require developers to move modified programs from the development environment to the test environment and from the test environment to the production environment.
- III. Eliminate access by developers to the production environment.

- A. I only.
- B. III only.
- C. I and II only.

D. I and III only.

**Answer:** D

**QUESTION:** 139

Which of the following types of internal audit consulting engagements is an example of a facilitation service?

I. Conducting control self assessment workshops.

II. Participating on standing committees.

III. Reviewing regulatory compliance.

IV. Benchmarking.

V. Estimating savings from outsourcing processes.

A. I and IV only.

B. I, III, and IV only.

C. II, III, and V only.

D. I, II, III, IV, and V.

**Answer:** A

**QUESTION:** 140

Which of the following are typical steps in the design of an organization's performance measurement system?

A. Understand organizational strategy; perform a situational assessment; establish measurement categories; and take actions based upon measurement results.

B. Categorize performance measures; establish a data collection plan; analyze data; and predict future performance.

C. Establish a measurement plan; create an organizational strategy linked to those measurements; trend measurement data; and measure data variability.

D. Perform a situational assessment; generate macro measurements; review measurement data; and change strategy based upon measurement results.

**Answer:** A

**QUESTION:** 141

An audit identified a number of weaknesses in the configuration of a critical client/server system. Although some of the weaknesses were corrected prior to the issuance of the audit report, correction of the rest will require between six and 18 months for completion.

Consequently, management has developed a detailed action plan, with anticipated completion dates, for addressing the weaknesses. Which of the following is the most appropriate course of action for the chief audit executive to take?

- A. Assess the adequacy of the action plan and monitor key dates and deliverables.
- B. Schedule a followup audit engagement to assess the status of corrective action.
- C. Reassign information systems auditors to assist the information technology department in correcting the weaknesses.
- D. Evaluate statistics related to unplanned system outages, unauthorized access attempts, and denials of service to assess the effectiveness of corrections.

**Answer:** A

**QUESTION:** 142

When conducting audit followup of a finding related to cash management routines, an internal auditor would expect to find that all of the following changes have occurred **except**

- A. The steps being taken are resolving the condition disclosed by the finding.
- B. Inherent risk **has been eliminated** as a result of resolution of the condition.
- C. Controls have been implemented to deter or detect a recurrence of the finding.
- D. Benefits have accrued to the entity as a result of resolving the condition.

**Answer:** B

**QUESTION:** 143

The internal audit activity's responsibility to follow up on reported audit findings should be defined in the

- A. Engagement memo issued prior to each audit assignment.
- B. Mission statement of the audit committee.
- C. Internal audit activity's written charter.
- D. Purpose statement within the applicable audit report.

**Answer:** C

**QUESTION:** 144

Which of the following does not represent a difficulty in using red flags as fraud indicators?

- A. Many common red flags are also associated with situations where no fraud exists.
- B. Some red flags are difficult to quantify or to evaluate.
- C. Red flag information is only gathered in extraordinary circumstances.
- D. The red flags literature is not well enough established to have a positive impact on auditing.

**Answer:** D

**QUESTION:** 145

The most common motivation for management fraud is the existence of

- A. Vices, such as a gambling habit.
- B. Job dissatisfaction.
- C. Financial pressures on the organization.
- D. The challenge of committing the perfect crime.

**Answer:** C

**QUESTION:** 146

Which of the following procedures would be most helpful in providing additional evidence when an auditor suspects that an unidentified employee is submitting and approving invoices for payment?

- A. Use generalized audit software to identify invoices from vendors with post office box numbers or other unusual features. Select a sample of those invoices and trace to supporting documents such as receiving reports.
- B. Select a sample of payments made during the year and investigate each one for approval.
- C. Select a sample of receiving reports representative of the period under investigation and trace to approved payment. Note any items not properly processed.
- D. Select a sample of invoices paid during the past month and trace them to appropriate vendor accounts.

**Answer:** A



**QUESTION:** 147

Which of the following is a red flag associated with improper asset valuation?

- A. Unusual increase in gross margin.
- B. Unusual decrease in the number of days' purchases in inventory.
- C. Recurring positive cash flows from operations.
- D. Allowance for bad debts that is increasing in percentage terms.

**Answer:** A

**QUESTION:** 148

An auditor selected a random sample of 100 items from a population of 2,000 items. The total dollars in the sample were \$10,000, and the standard deviation was \$10. If the achieved precision based on this sample was plus or minus \$4,000, the minimum acceptable value of the population would be

- A. \$196,000
- B. \$199,000
- C. \$199,800
- D. \$204,000

**Answer:** A

**QUESTION:** 149

If an auditor is sampling to test compliance with a particular company policy, which of the following factors should not affect the allowable level of sampling risk?

- A. The experience and knowledge of the auditor.
- B. The adverse consequences of noncompliance.
- C. The acceptable level of risk of making an incorrect audit conclusion.
- D. The cost of performing auditing procedures on sample selections.

**Answer:** A

**QUESTION:** 150

All of the following tools are employed to control large scale projects except

- A. Program evaluation and review technique (PERT).
- B. Critical path method.
- C. Statistical process control.
- D. Gantt charts.

**Answer:** C

**QUESTION:** 151

Which of the following is not an advantage of face to face interviews over mail surveys?

- A. The response rate is typically higher.
- B. Interviewers can increase a respondent's comprehension of questions.
- C. Survey designers can use a wider variety of QUESTION: types.
- D. They are less expensive since mailing costs are avoided.

**Answer:** D

**QUESTION:** 152

The use of standard operating procedure questionnaires in audit fieldwork can be beneficial because

- A. These questionnaires can both identify discrepancies and educate clients.
- B. Standard operating procedures are essential to the effectiveness and efficiency of operations.
- C. These questionnaires are more comprehensive than are other types of techniques for gathering data during fieldwork.
- D. These questionnaires do not normally require prior clearance with management of the audited area.

**Answer:** A

**QUESTION:** 153

Which of the following is the correct ratio to use in calculating the dollar value of the population if the auditor is using ratio estimation?

- Number of Items
- Audited Value
- Carrying Amount

Sample  
300  
\$500,000  
\$480,000  
Population  
3,000  
\$5,000,000

- A. 0.1
- B. 0.96
- C. 1.04
- D. 10.00

**Answer:** C

**QUESTION:** 154

One method for dealing with the uncertainty of demand forecasts used in linear programming is to extend the model solution to include

- A. Sensitivity analysis.
- B. Goal seeking.
- C. Branch and bound solutions.
- D. Nonlinear programming.

**Answer:** A

**QUESTION:** 155

Which of the following factors is least essential to a successful control self assessment workshop?

- A. Voting technology.
- B. Facilitation training.
- C. Prior planning.
- D. Group dynamics.

**Answer:** A

**QUESTION:** 156

Which is a key long-term objective of implementing control self-assessment (CSA)?

- A. Transfer assessment work traditionally performed by the CSA team to work unit personnel.
- B. Quickly gather large amounts of data on control deficiencies from work units, using voting technology.
- C. Improve control awareness and the ability of work unit personnel to manage risk.
- D. Reduce costs by identifying opportunities to improve efficiencies.

**Answer:** C

**QUESTION:** 157

Which of the following audit techniques provides for continuous monitoring and analysis of computer transactions for detailed auditing?

- A. Integrated test facility.
- B. Parallel simulation.
- C. Test data.
- D. Embedded audit routines.

**Answer:** D

**QUESTION:** 158

In obtaining accounts receivable confirmations, an auditor would most likely use generalized audit software to

- A. Test the results of calculations.
- B. Compare data from other audit procedures.
- C. Select and print accounts to be confirmed.
- D. Determine the accuracy of individual accounts.

**Answer:** C

**QUESTION:** 159

Access control software on an organization's mainframe computer records detailed information concerning both successful and unsuccessful log on attempts to applications.

Which of the following audit tools would be best suited to review the access information that has been recorded?

- A. Generalized audit software.
- B. Flowcharting.
- C. Integrated test facility.
- D. Test data.

**Answer:** A

**QUESTION:** 160

As part of a preliminary survey, a staff auditor has been assigned to flowchart the purchasing process for office supplies. Which source of audit evidence would provide the least value in flowcharting the process?

- A. An interview with the purchasing supervisor.
- B. A review of a sample of purchase orders which were completed during the last month.
- C. A review of the purchasing policies and procedures manual.
- D. A walk through of the process with a member of the purchasing staff.

**Answer:** B

**QUESTION:** 161

Which of the following steps is necessary to provide a summary level description of a complex new computer system?

- A. Prepare a control flowchart.
- B. Perform program code checking and flowchart verification.
- C. Prepare a system flowchart.
- D. Prepare a detailed narrative.

**Answer:** C

**QUESTION:** 162

Which of the following factors should be considered in determining the timing, nature, and extent of followup procedures?

- I. The significance of the audit observation.

- II. The time, effort, and cost needed to correct the reported condition.
- III. The complexity of the corrective action.
- IV. The potential consequences if the corrective action fails.

- A. I and IV only.
- B. II and III only.
- C. I, II, and III only.
- D. I, II, III, and IV.

**Answer:** D

**QUESTION:** 163

A warehouse manager for a supply company stated that products are shipped on a timely basis. During a preliminary walk through, an internal auditor observes some instances of delayed shipping. What can the auditor logically conclude from this contradictory information?

- A. The warehouse manager does not understand the operations.
- B. The auditor's observations were not representative of the population.
- C. Internal controls over customer orders are weak.
- D. Additional information is needed before a conclusion can be drawn.

**Answer:** D

**QUESTION:** 164

During an audit of a manufacturing facility, an internal auditor noted violations of regulations related to the disposal of hazardous chemicals. The most appropriate action for the auditor to take would be to

- A. Issue a written report to the committee that oversees regulatory compliance issues.
- B. Omit the finding in the written audit report, but orally request that facility management change procedures to appropriately dispose of the chemicals.
- C. Anonymously report the finding via the organization's compliance hot line.
- D. Consult with legal counsel regarding an appropriate course of action before reporting the finding.

**Answer:** D

**QUESTION: 165**

An anonymous party contacted an organization's fraud hotline and reported that the chief executive officer (CEO) and chief financial officer (CFO) were manipulating financial reserve accounts in order to achieve publicly disclosed earnings targets. All reports to the fraud hotline go directly to the entity's chief audit executive (CAE). Based on a preliminary evaluation of the report, the CAE concluded that the allegations were credible. Which of the following is the most appropriate course of action for the CAE to take?

- A. Contact the audit committee chairperson and request that an investigation be initiated by an outside party.
- B. Discuss the allegations with the entity's chief legal officer to determine if criminal charges should be filed against the CEO and CFO.
- C. Discuss the situation with the CEO and CFO because they are within the CAE's normal chain of command.
- D. Notify outside regulatory authorities that oversee financial reporting matters.

**Answer: A**

**QUESTION: 166**

When reviewing a report prepared by an internal auditor who has a personal friend employed in the area being audited, a chief audit executive's primary focus would be to ensure that the report

- A. Is fair, impartial, and unbiased.
- B. Is easily understood and findings are presented in a logical manner.
- C. Is clearly worded and avoids unnecessary detail, redundancy, and wordiness.
- D. Is free from errors and misstatements.

**Answer: A**

**QUESTION: 167**

In order to reduce the costs of processing and paying for small purchases, an organization issued credit cards for use by selected employees to purchase small amounts of expendable goods and services. An internal auditor tested controls over the use of the credit cards and documented the findings in the audit observation. Which of the following statements represents the **cause of** the audit observation?

- A. Four of the 30 tested transactions appeared to represent a single purchase of a personal computer, which in total exceeded \$1,950.
- B. Company policy limits card use to \$500 per transaction.
- C. An interview with the card provider's customer representative indicated that an automated control feature designed to identify and report on split purchase transactions had not been activated for the organization's credit card system.
- D. The personal computer purchased via the split purchase was not placed into the organization's capital equipment management system because it had not been acquired through the regular capital asset purchasing system. As a result, it was not subject to depreciation nor was it insured against theft.

**Answer:** C

**QUESTION:** 168

In order to reduce the costs of processing and paying for small purchases, an organization issued credit cards for use by selected employees to purchase small amounts of expendable goods and services. An internal auditor tested controls over the use of the credit cards and documented the findings in the audit observation. Which of the following statements represents the criterion of the audit observation?

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- C. An interview with the card provider's customer representative indicated that an automated control feature designed to identify and report on split purchase transactions had not been activated for the organization's credit card system.
- D. The personal computer purchased via the split purchase was not placed into the organization's capital equipment management system because it had not been acquired through the regular capital asset purchasing system. As a result, it was not subject to depreciation nor was it insured against theft.

**Answer:** B

**QUESTION:** 169

When an order to a supplier for an unusually large number of parts is entered in a company's computerized system, the system prompts the company's senior management to review the transaction. This is an example of which of the following information technology controls?

- A. Logic test.



- B. Check digits.
- C. Data reasonableness tests.
- D. Balancing control activities.

**Answer:** C

**QUESTION:** 170

Which of the following is true regarding the internal audit activity's management of a third-party consulting engagement?

- A. The consultant should be empowered to lead the engagement as deemed necessary to meet the audit objectives.
- B. The internal auditor should understand the work of the consultant and ensure that audit objectives are being met.
- C. The consultant should issue the final audit report if the auditor does not have the technical expertise to discuss the issues.
- D. The auditor may provide advice but has no responsibility for the final audit report issued by the consultant.

**Answer:** B

**QUESTION:** 171

The sampling method that is most appropriate to use when one deviation is considered critical is

- A. Sequential sampling.
- B. Mean per unit sampling.
- C. Ratio estimation sampling.
- D. Discovery sampling.

**Answer:** D

**QUESTION:** 172

An internal auditor is examining a large population of data and suspects that some of the data may be fraudulent. Which of the following sampling techniques would be most appropriate for the internal auditor to use?

- A. Random number sampling.

- B. Interval sampling.
- C. Stop and go sampling.
- D. Discovery sampling.

**Answer:** D

**QUESTION:** 173

During an audit, an internal auditor notes that the following situations exist Unusual profitability compared to other companies in the same industry. Highly complex transactions close to the end of the period. Significant sales to entities whose substance and ownership are not known. Unusual growth in the number of days sales in receivables. These situations indicate what type of fraud?

- A. Employee collusion with customer firms.
- B. Fictitious revenues.
- C. Improper asset valuation.
- D. Inventory theft.

**Answer:** B

**QUESTION:** 174

By using an appropriate method of selecting sample items from the population, an auditor

- A. Reduces sampling risk.
- B. Reduces nonsampling risk.
- C. Increases the sample size.
- D. Reduces the sample size.

**Answer:** A

**QUESTION:** 175

Which of the following would be the appropriate analytical approach when comparing the number of employees working at a factory site with the direct cost of production each month over a period of one year?

- A. Trend analysis.
- B. Ratio analysis.

C. Regression analysis.

D. Horizontal analysis.

**Answer:** C

**QUESTION:** 176

Observation is most effective in addressing which of the following management assertions?

A. Valuation.

B. Existence.

C. Completeness.

D. Accuracy.

**Answer:** B

**QUESTION:** 177

Which of the following issues could be identified through observation without corroborative evidence?

I. Indicators of security or safety violations.

II. Significant production output differences during the previous year.

III. A backlog indicated by large amounts of unprocessed paperwork.

IV. Workflow procedures that are not logical and may unnecessarily add work to the process.

A. I only.

B. I and III only.

C. I, III, and IV only.

D. II, III, and IV only.

**Answer:** B

**QUESTION:** 178

In what order should the following actions be taken by an internal auditor when planning to analyze data using computer assisted audit techniques?

I. Define the procedures to be undertaken.

II. Define the output requirements.

III. Set the objectives.

IV. Obtain access to appropriate data.

- A. III, II, I, IV.
- B. II, III, IV, I.
- C. III, IV, I, II.
- D. IV, III, II, I.

**Answer:** A

**QUESTION:** 179

A fire destroyed a large portion of an organization's inventory. Should management be permitted to use the internal auditors' workpapers to file an insurance claim as a result of the fire?

- A. No. Workpapers cannot be used to prepare the claims.
- B. Yes. Workpapers can be used to prepare the claim, but such use should be approved by the chief audit executive.
- C. No. Workpapers cannot be provided to management, but the claim could be performed by the internal audit activity.
- D. Yes. Workpapers can be used to prepare the claim but must first be approved by the organization's external auditors.

**Answer:** B

**QUESTION:** 180

In which of the following situations should internal auditors report fraud to senior management and the board?

- A. Irregular transactions have been identified and are under investigation.
- B. Suspicious activities have been reported to the internal auditors.
- C. Significant fraud has been established to a reasonable certainty.
- D. Review of all suspected fraud related transactions is complete.

**Answer:** C

**QUESTION:** 181

A chief audit executive (CAE) of a major retailer has engaged an independent firm of information security specialists to perform specialized internal audit activities. The CAE can rely on the specialists' work only if it is

- A. Performed in accordance with the terms of the contract.
- B. Carried out in accordance with the Standards.
- C. Performed under the supervision of the information technology department.
- D. Carried out using standard review procedures for retailers.

**Answer:** B

**QUESTION:** 182

Which of the following actions by management would reduce an employee's opportunity to commit fraud?

- A. Establishing physical controls over company assets.
- B. Eliminating bonuses tied to sales or other performance goals.
- C. Defining ethical behavior expectations in the company handbook.
- D. Identifying consequences, such as termination, for fraudulent activities.

**Answer:** A

**QUESTION:** 183

Which of the following best defines an engagement conclusion?

- A. An auditor's determination of the cause of an engagement observation.
- B. An auditor's professional judgment of the situation which was reviewed.
- C. An opinion that must be included in the engagement final communication.
- D. A recommendation for corrective action.

**Answer:** B

**QUESTION:** 184

During an audit of a retail organization, an internal auditor found a scheme in which the warehouse director and the purchasing agent diverted approximately \$500,000 of goods to their own warehouse, then sold the goods to third parties. The fraud was not found earlier since the warehouse director updated the perpetual inventory records and then forwarded receiving reports to the accounts payable department for processing. Which of the following procedures would have most likely led to the discovery of the missing materials and the fraud?

- A. Select a random sample of receiving reports and trace to the recording in the perpetual inventory records. Note differences and investigate by type of product.
- B. Select a random sample of purchase orders and trace to receiving reports and to the records in the accounts payable department.
- C. Take an annual physical inventory, reconciling amounts with the perpetual inventory records. Note the pattern of differences and investigate.
- D. Select a random sample of sales invoices and trace to the perpetual inventory records to see if inventory was on hand. Investigate any differences.

**Answer:** C

**QUESTION:** 185

While conducting a payroll audit, an internal auditor in a large government organization found inadequate segregation in the duties assigned to the assistant director of personnel. When the auditor explained the risk of fraud, the assistant director became upset, terminated the interview, and threatened to sue the organization for defamation of character if the audit engagement was not curtailed. The auditor discussed the situation with the chief audit executive (CAE). The CAE should then

- A. Curtail the audit engagement to avoid potential legal action.
- B. Provide a report to senior management recommending a fraud investigation.
- C. Continue the original engagement program as planned but include a comment about the assistant director's reaction in the engagement final communication.
- D. Add additional testing to determine whether other indicators of fraud exist.

**Answer:** D

**QUESTION:** 186

Which of the following files, when compared with billing records, would provide the best source of information for determining if all goods shipped are billed to customers?

- A. Prenumbered customer invoices.
- B. Accounts receivable transactions.
- C. Prenumbered shipping documents.
- D. Customer purchase orders.

**Answer:** C

**QUESTION: 187**

The following are potential sources of evidence regarding the effectiveness of a division's total quality management program. The least persuasive evidence would be a comparison of

- A. Employee morale before and after program implementation.
- B. Scrap and rework costs before and after program implementation.
- C. Customer returns before and after program implementation.
- D. Manufacturing and distribution costs per unit before and after program implementation.

**Answer: A**

**QUESTION: 188**

A company's policy requires that all customers be treated in a fair and consistent manner. Which of the following audit procedures would provide the most persuasive evidence that the policy was followed?

- A. Compare the aging of outstanding receivables due from each customer.
- B. Compare credit reports with annual sales for a sample of customers.
- C. Compare the ratio of outstanding receivables to the authorized credit limit for each customer.
- D. Compare the sales discounts offered to each customer.

**Answer: D**

**QUESTION: 189**

New credit policies have been implemented in an automated order entry system to improve the collection of receivables. Sales management has compiled several examples that show decreased sales and delayed order entry, and contends that these examples are a direct result of the new credit policy constraints. Sales management's data and information provide

- A. Feedback control data.
- B. Irrelevant and argumentative information.
- C. Evidence that the new credit policies do not meet the stated corporate objective to improve collections.
- D. A statistically valid conclusion about the impact of the new credit policies on customer goodwill.

**Answer:** A

**QUESTION:** 190

An auditor prepared a workpaper that consisted of a list of employee names and identification numbers as well as the following statement . A statistical sample of 40 employee personnel files was selected to verify that they contain all documents required by company policy 501 (copy attached). No exceptions were noted. The auditor did not place any audit verification symbols on this workpaper. Which of the following changes would most improve the auditor's workpaper?

- A. Use of audit verification symbols to show that each file was examined.
- B. Removal of the employee names to protect their confidentiality.
- C. Justification for the sample size.
- D. Listing of the actual documents examined for each employee.

**Answer:** C

**QUESTION:** 191

Productivity statistics are provided quarterly to a company's board of directors. An auditor checked the ratios and other statistics in the four most recent reports. The auditor used scratch paper and copies of the board reports to verify the accuracy of computations and compared the data used in the computations with supporting documents. The auditor wrote a note describing this work for the workpapers and then discarded the scratch paper and report copies. The auditor's note stated .The ratios and other statistics in the quarterly board reports were checked for the last four quarters, and appropriate supporting documents were examined. All amounts appear to be appropriate. In this situation

- A. Four quarters is not a large enough sample on which to base a conclusion.
- B. The auditor's workpapers are not sufficient to facilitate an efficient review of the auditor's work.
- C. The auditor should have included the scratch paper in the workpapers.
- D. The auditor should have considered whether the information in the board report was compiled efficiently.

**Answer:** B



**QUESTION: 192**

When conducting research, which of the following is most important?

- A. Using computer databases or the Internet to find all relevant sources.
- B. Providing documentation of the reference sources.
- C. Presenting only those facts that support the conclusion.
- D. Presenting all contrary views to balance the opinion.

**Answer: B**

**QUESTION: 193**

Which of the following would provide the best evidence of compliance with an airline's standard of having aircraft refueled and cleaned within a specified time of arrival at an airport?

- A. Vendor fuel invoices that have been reconciled to inventory records.
- B. Time cards completed by aircraft cleaning and fueling crews.
- C. Observation of selected aircraft while they are being refueled and cleaned.
- D. Comparison of the standard hourly labor costs for cleaning and fueling personnel with actual labor charges.

**Answer: C**

**QUESTION: 194**

An internal audit activity implemented an integrated test facility to test payroll processing. The auditors identified the key controls and processing steps built into the computer program and developed test data to test them. The auditors submitted test transactions throughout the year and did not find any differences in their test results. The auditors can conclude that

- A. The system is properly capturing the hours worked by employees during the year and the hours have been properly submitted to payroll and processed correctly.
- B. All employees were correctly paid during the year and their pay was correctly computed.
- C. The computer application and its control procedures were processing payroll transactions correctly during the past year.
- D. All of the above.

**Answer: C**

**QUESTION: 195**

In preparing to facilitate a control self assessment session, an auditor would be least likely to ensure that

- A. Key stakeholders are represented in the group.
- B. An independent content expert is available to help settle disagreements.
- C. Background research is completed to familiarize the auditor with relevant issues.
- D. Management is consulted on the issues and priorities.

**Answer: B**

**QUESTION: 196**

What is the most important risk in determining the validity of construction delay claims?

- A. Contractor claims may be submitted prior to completion of the work.
- B. Contractor claims may include costs considered in the fixed price portion of the work.
- C. Contractor claims may include subcontractor estimates of balances due to the subcontractor.
- D. Contractor claims may be understated.

**Answer: B**

**QUESTION: 197**

An internal auditor is assigned to conduct an audit of security for a local area network (LAN) in the finance department of the organization. Investment decisions, including the use of hedging strategies and financial derivatives, use data and financial models which run on the LAN. The LAN is also used to download data from the mainframe to assist in decisions. Which of the following should be considered outside the scope of this security audit engagement?

- A. Investigation of the physical security over access to the components of the LAN.
- B. The ability of the LAN application to identify data items at the field or record level and implement user access security at that level.
- C. Interviews with users to determine their assessment of the level of security in the system and the vulnerability of the system to compromise.

D. The level of security of other LANs in the company which also utilize sensitive data.

**Answer:** D

**QUESTION:** 198

Which of the following items should be addressed in an organization's privacy statement?

- I. Intended use of collected information.
- II. Data storage and security.
- III. Network/infrastructure authentication controls
- IV. Data retention policy of the organization.
- V. Parties authorized to access information.

- A. I and II only
- B. I and IV only
- C. I, II, and V only
- D. II, III, IV, and V only

**Answer:** C

**QUESTION:** 199

During an audit of a branch bank, an internal auditor learned that a series of system failures had resulted in a four day delay in processing customers' scheduled payroll direct deposits. The first failure was that of a disk drive, followed by software and other minor failures. Which of the following controls should the auditor recommend to avoid similar delays in processing?

- A. Contingency planning
- B. Redundancy checks
- C. Process monitoring
- D. Preventive maintenance

**Answer:** A

**QUESTION:** 200

An auditor analyzed a payroll system's data files for unusual activity, such as excessive overtime hours, unusual fluctuations in pay rates, and excessive vacation time. The application controls being verified by this analysis are

- A. Edit and validation controls.
- B. Rejected and suspense item controls.
- C. Controls over update access to the database
- D. Programmed balancing controls.

**Answer:** A

**QUESTION:** 201

When internal auditors provide consulting services, the scope of the engagement is primarily determined by

- A. Internal auditing standards
- B. The audit engagement team.
- C. The engagement client
- D. The internal audit activity's charter.

**Answer:** C

**QUESTION:** 202

While investigating a compromised Web server, an auditor found that the Web server logs had been deleted. The auditor should recommend that the Web server logs be

- A. Generated and maintained on a separate secure server.
- B. Accessible by administrative users only.
- C. Encrypted to ensure that the logs cannot be deleted.
- D. Restored automatically to the Web server from backup files.

**Answer:** A

**QUESTION:** 203

In a review of an electronic data interchange application using a third party service provider, the auditor should

- I. Ensure encryption keys meet International Organization for Standardization (ISO) standards.
- II. Determine whether an independent review of the service provider's operation has been conducted.

- III. Verify that only public switched data networks are used by the service provider.
- IV. Verify that the service provider's contracts include necessary clauses, such as the right to audit.

- A. I and II only.
- B. I and IV only.
- C. II and III only.
- D. II and IV only.

**Answer:** D

**QUESTION:** 204

Which of the following must an auditor establish in order to demonstrate that fraud has occurred?

- A. Monetary damage to the victim.
- B. The suspect's intent
- C. Existence of an internal control deficiency
- D. Evidence of collusion

**Answer:** B

**QUESTION:** 205

Which of the following situations might allow an employee to steal checks sent to an organization and subsequently cash them?

- A. Checks are not restrictively endorsed when received.
- B. Only one signature is required on the organization's checks.
- C. One employee handles both accounts receivable and purchase orders.
- D. One employee handles both cash deposits and accounts payable.

**Answer:** A

**QUESTION:** 206

When assessing the risk associated with an activity, an internal auditor should

- A. Determine how the risk should best be managed
- B. Provide assurance on the management of the risk
- C. Modify the risk management process based on risk exposures.
- D. Design controls to mitigate the identified risks

**Answer:** B

**QUESTION:** 207

Which of the following factors would not be considered in determining appropriate followup procedures?

- A. The significance of the audit finding
- B. The effort and cost needed to correct the reported condition.
- C. The availability of funds in the audited department's budget to correct the reported condition.
- D. The potential consequences if the corrective action fails.

**Answer:** C

**QUESTION:** 208

After partially completing an internal control review of the accounts payable department, an auditor suspects that some type of fraud has occurred. To ascertain whether the fraud is present, the best sampling approach would be to use

- A. Simple random sampling to select a sample of vouchers processed by the department during the past year.
- B. Probability proportional to size sampling to select a sample of vouchers processed by the department during the past year.
- C. Discovery sampling to select a sample of vouchers processed by the department during the past year.
- D. Judgmental sampling to select a sample of vouchers processed by clerks who were identified by the department manager as acting suspiciously.

**Answer:** C

**QUESTION:** 209

When interviewing an individual suspected of fraud, what type of questions would be asked after the introductory questions?

- A. Informational questions.
- B. Admission seeking questions
- C. Assessment questions
- D. Closing questions

**Answer:** A

**QUESTION:** 210

A chief audit executive (CAE) suspects that several employees have used desktop computers for personal gain. In conducting an investigation, the primary reason that the CAE would choose to engage a forensic information systems auditor rather than using the organization's information systems auditor is that a forensic information systems auditor would possess

- A. Knowledge of the computing system that would enable a more comprehensive assessment of the computer use and abuse.
- B. Knowledge of what constitutes evidence acceptable in a court of law.
- C. Superior analytical skills that would facilitate the identification of computer abuse.
- D. Superior documentation and organization skills that would facilitate in the presentation of findings to senior management and the board.

**Answer:** B

**QUESTION:** 211

During an audit of a major contract, an auditor finds that actual hours and dollars billed are consistently at or near budgeted amounts. This condition is a red flag for which of the following procurement fraud schemes?

- A. Defective pricing
- B. Cost mischarging.
- C. Fictitious vendor
- D. Bid rotation

**Answer:** B

**QUESTION: 212**

If an auditor used nonstatistical sampling instead of statistical sampling to estimate the value of inventory, which of the following would be true?

- A. The confidence level could not be quantified.
- B. The precision would be larger
- C. The projected value of inventory would be less reliable
- D. The risk of incorrect acceptance would be higher

**Answer: A**

**QUESTION: 213**

If an auditor expects to find numerous discrepancies between recorded values and audited values of sample selections, which sampling technique would be most appropriate?

- A. Attributes sampling
- B. Probability proportional to size sampling
- C. Difference estimation sampling
- D. Discovery sampling

**Answer: C**

**QUESTION: 214**

Which of the following factors would increase the confidence level in a variables sampling plan?

- I. A larger sample size
- II. A stratified sample
- III. A larger standard deviation

- A. I and II only
- B. I and III only
- C. II and III only
- D. I, II, and III

**Answer: A**

**QUESTION: 215**

A fast food company is developing a computer simulation involving arrival time at a



drive through restaurant. The distribution for arrival times is

Time Between Arrivals	Probability	Single Digit Random Number Assigned
1 minute	0.1	0
2 minute	0.2	1,2
3 minute	0.3	3,4,5
4 minute	0.4	6,7,8,9

Six random numbers are selected to represent the arrival of six cars 1, 6, 9, 0, 5, 6. The mean time between arrivals for these cars, in this run of the simulation model, is

- A. 1 minute
- B. 2 minute
- C. 3 minute**
- D. 4 minute

**Answer:** C

**QUESTION:** 216

An internal auditor is discussing an audit problem with an engagement client. While listening to the client, the internal auditor should

- A. Prepare a response to the client
- B. Take mental notes on the speaker's nonverbal communication, as it is more important than what is being said.
- C. Make sure that all details, as well as the main ideas of the client, are remembered.
- D. Integrate the incoming information from the client with information that is already known.

**Answer:** D

**QUESTION:** 217

An auditor used a questionnaire during an interview to gather information about the nature of credit sales processing. The questionnaire did not cover some pertinent information offered by the person being interviewed, and the auditor did not document the potential problems for further investigation. The primary deficiency with the above process is that

- A. The auditor failed to consider the importance of the information offered.
- B. A questionnaire was used in a situation where a structured interview should have been used.

- C. Using a questionnaire precludes the auditor from documenting other information.
- D. The engagement program was incomplete.

**Answer:** A

**QUESTION:** 218

Checklists used to assess audit risk have been criticized for all of the following reasons except

- A. Providing a false sense of security that all relevant factors are addressed.
- B. Inappropriately implying equal weight to each item on the checklist.
- C. Decreasing the uniformity of data acquisition
- D. Being incapable of translating the experience or sound reasoning intended to be captured by each item on the checklist.

**Answer:** C

**QUESTION:** 219

After completing a net present value (NPV) calculation on a proposed project, an analyst explores the change in NPV with changes in the interest rate. This additional analysis is referred to as

- A. Decision analysis
- B. Simulation
- C. Sensitivity analysis
- D. Variance analysis

**Answer:** C

**QUESTION:** 220

Which of the following factors could interfere with effective problem solving by an internal auditor?

- I. Reacting to previous experiences with clients
- II. Focusing only on the most likely cause
- III. Correcting the symptoms of problems

- A. I only
- B. III only

- C. I and II only
- D. I, II, and III

**Answer:** D

**QUESTION:** 221

Which of the following would not be characteristic of control self assessment implemented by an audit department?

- A. An auditor usually facilitates the discussion during the workshop phase while another records comments for subsequent use.
- B. Auditors and business unit employees work as a team.
- C. Auditors perform traditional audit tests to identify control weaknesses.
- D. Participants discuss the control weaknesses that hinder the achievement of objectives.

**Answer:** C

**QUESTION:** 222

A retail company uses a computer program that matches electronic vendor invoices with the applicable purchase orders and receiving information, which are also maintained electronically. If an invoice does not match the other items within predefined ranges, a report is generated and sent to the accounts payable department for further investigation. All of the applicable documents are electronically marked, cross referenced, and retained in open files. Both an integrated test facility and a systems control audit review file (SCARF) have been included in the system. An auditor wants to determine the extent to which items are not matched at year end and to investigate the potential causes of the unmatched items. Which of the following audit procedures would be most effective in determining the items to investigate?

- A. Use generalized audit software to read the electronically marked unmatched items.
- B. Use generalized audit software to read the purchase orders and trace to applicable receiving and vendor invoice files.
- C. Use the SCARF to identify unusual items. Select an attributes sample and trace to the underlying documentation.
- D. Submit test data to identify attributes of unmatched items

**Answer:** A

**QUESTION: 223**

Which of the following would be most helpful to a governmental auditor searching for the existence of multiple welfare claims that were filed under different names but used the same address?

- A. Tagging and tracing
- B. Generalized audit software
- C. Integrated test facility
- D. Spreadsheet analysis

**Answer: B**

**QUESTION: 224**

Which of the following is the best course of action for an internal auditor to take when new, relevant information is revealed immediately after an exit conference?

- A. Document the situation for future followup and continue with the next assignment.
- B. Request that management provide additional resources so that the audit can be extended.
- C. Postpone the next audit assignment and continue to investigate the issue.
- D. Report the issue immediately to senior management of the internal audit activity.

**Answer: D**

**QUESTION: 225**

Which of the following is true of engagement recommendations?

- I. Specific suggestions for implementation must be included.
- II. The internal auditor's observations and conclusions may serve as the basis.
- III. Actions to correct existing conditions or improve operations may be included.
- IV. Approaches to correcting or enhancing performance may be suggested.

- A. I only
- B. III only
- C. I, III, and IV only
- D. II, III, and IV only

**Answer: D**

**QUESTION: 226**

Which of the following is an example of the verification of internal documentary evidence?

- A. Reviewing a carrier's bill of lading
- B. Reconciling a vendor's month end statement
- C. Vouching a copy of a sales invoice to receivables
- D. Recalculating a customer's purchase order

**Answer: C**

**QUESTION: 227**

Which of the following would provide the least assurance about the operating effectiveness of an internal control?

- A. Interviews with the client's personnel
- B. Analysis of system flowcharts
- C. Observation of the client's processes
- D. Inspection of documents and reports

**Answer: B**

**QUESTION: 228**

Which of the following audit procedures is most suitable for verifying that all sales transactions have been recorded?

- A. Observation
- B. Tracing
- C. Recomputation
- D. Vouching

**Answer: B**

**QUESTION: 229**

Which of the following statements regarding the review of workpapers is correct?

- A. Engagement workpapers should be approved by the client after completion.

- B. Workpapers that pertain to legal issues should be reviewed to ensure that all audit opinions and details are recorded.
- C. Workpaper review notes should be retained for all engagements.
- D. Workpapers should be initialed and dated by the reviewer as evidence of supervisory review.

**Answer:** D

**QUESTION:** 230

Which of the following is a red flag associated with fictitious revenues?

- A. Slow growth or unusually low profitability
- B. Unusual decrease in the number of days' sales in receivables
- C. Substantial increase in receivables turnover
- D. Significant transactions with related parties

**Answer:** D

**QUESTION:** 231

Which of the following methods of data collection would be most appropriate to use in identifying hypotheses that can be tested on a larger scale?

- A. Case study
- B. Sampling
- C. Evaluation synthesis
- D. Modeling

**Answer:** A

**QUESTION:** 232

Which of the following performance criteria would be most useful when measuring the performance of a customer service desk?

- A. The number of customer inquiries recorded per day
- B. The percentage of customer issues resolved within 24 hours
- C. The number of customer complaints recorded per day
- D. The percentage of total customers served per day

**Answer:** B

**QUESTION:** 233

Which of the following stakeholder groups is least likely to be involved in the development of an organization's performance scorecard?

- A. Senior managers
- B. Distributors**
- C. Middle managers
- D. Labor union representatives

**Answer:** B

**QUESTION:** 234

Direct staff as a percentage of total staff is an example of which of the following types of efficiency measures?

- A. Productivity ratio
- B. Productivity index
- C. Operating ratio**
- D. Resource utilization rate

**Answer:** C

**QUESTION:** 235

An auditor conducts a consulting engagement that involves analysis and measurement of key outputs against those of best organizations as well as identification of key actions that contribute to the performance differences. What type of engagement does this represent?

- A. Assurance
- B. Compliance
- C. Due diligence
- D. Total quality management

**Answer:** D

**QUESTION:** 236

According to the International Professional Practices Framework, which of the following should be considered when determining appropriate followup procedures?

- A. Complexity of the corrective action
- B. Availability of audit staff
- C. Availability of area management
- D. Inherent risk assessment of the area

**Answer:** A

**QUESTION:** 237

Which of the following situations would best support the decision of a chief audit executive (CAE) to defer followup activity at a branch office until the next audit engagement?

- A. An audit of the branch office is routinely scheduled every three years.
- B. On site followup of a remote branch may not be feasible due to travel costs.
- C. Branch office management states that correction of the audit issue may take longer than expected.
- D. The CAE and management agree that the corrective action taken to date is sufficient.

**Answer:** D

**QUESTION:** 238

Which of the following is not a factor to be considered in discovery sampling?

- A. Population size
- B. Error rate
- C. Cost per sample observation
- D. Confidence level

**Answer:** C



**QUESTION: 239**

During a routine audit of a customer service hotline, an internal auditor noticed that an unusually high number of customer complaints pertained to payments not being applied to the customers' accounts. Which of the following would most likely be the reason for the high volume of complaints?

- A. An ineffective customer service department
- B. Poor controls in the invoice approval processes
- C. Check tampering by an employee
- D. Submission of fraudulent expense reports

**Answer: C**

**QUESTION: 240**

Which of the following analysis techniques would be most useful in identifying the causes of adverse conditions?

- A. Fishbone diagrams
- B. Gantt charts
- C. Pareto diagrams
- D. System flowcharts

**Answer: A**

**QUESTION: 241**

What type of analysis is performed when an auditor tests for unusual variations in information by comparing the number of employees working at a factory site with the direct cost of production each month over a period of one year?

- A. Trend analysis
- B. Ratio analysis
- C. Regression analysis
- D. Horizontal analysis

**Answer: C**

**QUESTION: 242**

Which of the following analysis techniques would be most useful to an internal auditor in determining the **priority of adverse conditions** to be addressed?

- A. Fishbone diagram
- B. Flowcharting
- C. Histogram
- D. **Pareto chart**

**Answer:** D

**QUESTION:** 243

Which of the following types of audit evidence is best defined as the proof of a fact without reliance on presumptions for support?

- A. Direct.
- B. Circumstantial.
- C. Conclusive.
- D. Corroborative.

**Answer:**

Pending. Please put your suggestions to [terry@troytec.com](mailto:terry@troytec.com)

**QUESTION:** 244

The balanced scorecard approach differs from traditional performance measurement approaches because it adds which of the following measures?

- I. **Financial measures**
- II. Internal business process measures
- III. Client satisfaction measures
- IV. Innovation and learning measures

- A. I only
- B. II and IV only
- C. III and IV only
- D. **II, III, and IV only**

**Answer:** D

**Section 1: Sec One (1 to 157)**

**Details: Business Performance**

The management and employees of a large household goods moving company decided to adopt total quality management (TQM) and continuous improvement (CI). The company believes that if it became nationally known as adhering to TQM and CI, one result would be an increase in the company's profits and market share.

**QUESTION: 1**

The primary reason for adopting TQM was to achieve

- A. Greater customer satisfaction.
- B. Reduced delivery time.
- C. Reduced delivery charges.
- D. Greater employee participation.

**Answer: A**

TQM is an integrated system that anticipates, meets, and exceeds customers needs, wants, and expectations. The management and employees of a large household goods moving company decided to adopt total quality management (TQM) and continuous improvement (CI). The company believes that if it became nationally known as adhering to TQM and CI, one result would be an increase in the company's profits and market share.

**QUESTION: 2**

What should the company focus on to achieve quality more economically?

- A. Appraisal costs.
- B. Prevention costs.
- C. Internal failure costs.
- D. External failure costs.

**Answer: B**

Prevention attempts to avoid defective output. Prevention costs include preventive maintenance, employee training, review of equipment design, and evaluation of suppliers. Prevention is less costly than detection and correction of defective output.

**QUESTION: 3**

A traditional quality control process in manufacturing consists of mass inspection of goods only at the end of a production process. A major deficiency of the traditional control process is that

- A. It is expensive to do the inspections at the end of the process.
- B. It is not possible to rework defective items.
- C. It is not 100% effective.
- D. It does not focus on improving the entire production process.

**Answer:** D

The process used to produce the goods is not thoroughly reviewed and evaluated for efficiency and effectiveness. Preventing defects and increasing efficiency by improving the production process raises quality standards and decreases costs.

**QUESTION:** 4

Under a total quality management (TQM) approach,

- A. Measurement occurs throughout the process, and errors are caught and corrected at the source.
- B. Quality control is performed by highly trained inspectors at the end of the production process.
- C. Upper management assumes the primary responsibility for the quality of the products and services.
- D. A large number of suppliers are used in order to obtain the lowest possible prices.

**Answer:** A

Total quality management emphasizes quality as a basic organizational function. TQM is the continuous pursuit of quality in every aspect of organizational activities. One of the basic tenets of TQM is doing it right the first time. Thus, errors should be caught and corrected at the source.

**QUESTION:** 5

Which of the following is a characteristic of total quality management (TQM)?

- A. Management by objectives.
- B. On-the-job training by other workers.
- C. Quality by final inspection.
- D. Education and self-improvement.

**Answer:** D

According to management theorist W. Edwards Deming's well-known 14 points, education and self-improvement are essential. Knowledge is opportunity. Hence, continuous improvement should be everyone's primary career objective.

**QUESTION: 6**

In which of the following organizational structures does total quality management (TQM) work best?

- A. Hierarchical.
- B. Teams of people from the same specialty.
- C. Teams of people from different specialties.
- D. Specialists working individually.

**Answer: C**

TQM advocates replacement of the traditional hierarchical structure with teams of people from different specialties. This change follows from TQM's emphasis on empowering employees and teamwork. Employees should have proper training, necessary information, and the best tools; be fully engaged in the decision process; and receive fair compensation. If such empowered employees are assembled in teams of individuals with the required skills, TQM theorists believe they will be more effective than people performing their tasks separately in a rigid structure.

**QUESTION: 7**

The most important component of quality control is

- A. Ensuring goods and services conform to the design specifications.
- B. Satisfying upper management.
- C. Conforming with ISO-9000 specifications.
- D. Determining the appropriate timing of inspections.

**Answer: A**

The intent of quality control is to ensure that goods and services conform to the design specifications. Whether the focus is on feedforward, feedback, or concurrent control, the emphasis is on ensuring product or service conformity.

**QUESTION: 8**

The cost of scrap, rework, and tooling changes in a product quality cost system is categorized as a(n)

- A. Training cost.
- B. External failure cost.
- C. Internal failure cost.
- D. Prevention cost.

**Answer: C**

Internal failure costs are incurred when detection of defective products occurs before shipment. Examples of internal failure costs are scrap, rework, tooling changes, and downtime.

**QUESTION: 9**

The four categories of costs associated with product quality costs are

- A. External failure, internal failure, prevention, and carrying.
- B. External failure, internal failure, prevention, and appraisal.
- C. External failure, internal failure, training, and appraisal.
- D. Warranty, product liability, training, and appraisal.

**Answer: B**

The following are the four categories of quality costs: prevention, appraisal, internal failure, and external failure (lost opportunity). Costs of prevention include attempts to avoid defective output, including employee training, review of equipment design, preventive maintenance, and evaluation of suppliers. Appraisal costs include quality control programs, inspection, and testing. Internal failure costs are incurred when detection of defective products occurs before shipment, including scrap, rework, tooling changes, and downtime. External failure costs are incurred after the product has been shipped, including the costs associated with warranties, product liability, and customer ill will.

**QUESTION: 10**

The cost of statistical quality control in a product quality cost system is categorized as a n)

- A. Internal failure cost.
- B. Training cost.
- C. External failure cost.
- D. Appraisal cost.

**Answer: D**

The following are the four categories of quality costs: prevention, appraisal, internal failure, and external failure (lost opportunity). Appraisal costs include quality control programs,

inspection, and testing. However, some authorities regard statistical quality and process control as preventive activities because they not only detect faulty work but also allow for adjustment of processes to avoid future defects.

**QUESTION: 11**

Listed below are selected line items from the cost-of-quality report for Company B for

Category	Amount
Rework	US \$ 725
Equipment maintenance	1,154
Product testing	786
Product repair	695

What is Company B's total prevention and appraisal cost for last month?

- A. US \$786
- B. US \$1,154
- C. US \$1,940
- D. US \$2,665

**Answer: C**

The costs of prevention and appraisal are conformance costs that serve as financial measures of internal performance. Prevention costs are incurred to prevent defective output. These costs include preventive maintenance, employee training, review of equipment design, and evaluation of suppliers. Appraisal costs are incurred to detect nonconforming output. They embrace such activities as statistical quality control programs, inspection, and testing. The equipment maintenance cost of US \$1,154 is a prevention cost. The product testing cost of US \$786 is an appraisal cost. Their sum is US \$1,940.

**QUESTION: 12**

All of the following are generally included in a cost-of-quality report except

- A. Warranty claims.
- B. Design engineering.
- C. Supplier evaluations.
- D. Lost contribution margin.

**Answer: D**

A cost-of-quality report includes most costs related to quality, including the costs of external failure, internal failure, prevention, and appraisal. Lost contribution margins from poor product quality are external failure costs that normally do not appear on a cost-of-quality

report because they are opportunity costs. Opportunity costs are not usually recorded by the accounting system, thereby understating the costs of poor quality. Lost contribution margins from reduced sales, market share, and sales prices are external failure costs that are also not usually included in a cost-of-quality report.

**QUESTION: 13**

Conformance is how well a product and its components meet applicable standards. According to the robust quality concept,

- A. A certain percentage of defective units is acceptable.
- B. Units are acceptable if their characteristics lie within an acceptable range of values.
- C. The goal is for all units to be within specifications.
- D. Every unit should reach a target value.

**Answer: D**

Conformance is how well a product and its components meet applicable standards. The traditional view is that conforming products are those with characteristics that lie within an acceptable specified range of values that includes a target value. This view also regarded a certain percentage of defective (nonconforming) units as acceptable. The traditional view was superseded by the zero-defects approach that sought to eliminate all nonconforming output. An extension of this approach is the robust quality concept. Its goal is to reach the target value in every case. The reason is that hidden quality costs occur when output varies from the target even though the units are within specifications.

**QUESTION: 14**

The Plan-Do-Check-Act (PDCA) cycle is a quality tool devised by W. Edwards Deming. How is PDCA best described

- A. A "management by fact" approach to continuous improvement.
- B. An ongoing evaluation of the practices of best-in-class organizations.
- C. The translation of customer requirements into design requirements.
- D. The responsibility of every employee, work group, department, or supplier to inspect the work.

**Answer: A**

PDCA is a "management by fact" or scientific method approach to continuous improvement. PDCA creates a process-centered environment because it involves studying the current process, collecting and analyzing data to identify causes of problems, planning for improvement, and deciding how to measure improvement (Plan). The plan is then implemented on a small scale if possible (Do). The next step is to determine what happened



Check). If the experiment was successful, the plan is fully implemented. The cycle is then repeated using what was learned from the preceding cycle.

**QUESTION: 15**

Which of the following quality costs are nonconformance costs?

- A. Systems development costs.
- B. Costs of inspecting in-process items.
- C. Environmental costs.
- D. Costs of quality circles.

**Answer: C**

Nonconformance costs include internal and external failure costs. External failure costs include environmental costs, e.g., fines for violations of environmental laws and loss of customer goodwill.

**QUESTION: 16**

Quality costing is similar in service and manufacturing organizations. Nevertheless, the differences between these organizations have certain implications for quality management. Thus,

- A. Direct labor costs are usually a higher percentage of total costs in manufacturing organizations.
- B. External failure costs are relatively greater in service organizations.
- C. Quality improvements resulting in more efficient use of labor time are more likely to be accepted by employees in service organizations.
- D. Poor service is less likely to result in loss of customers than a faulty product.

**Answer: B**

External failure costs arise when problems occur after delivery. They occur because products or services are nonconforming or otherwise do not satisfy customers. External failure costs in service enterprises are even more important than in manufacturing environments. Faulty goods sometimes may be reworked or replaced to a customer's satisfaction, but poor service tends to result in a loss of customers.

**QUESTION: 17**

An organization has adopted the robust quality approach. According to this view of quality,

- A. The minimum point on the total quality cost curve occurs when conformance cost per unit equals nonconformance cost per unit.
- B. Improving quality requires tradeoffs among categories of quality costs.
- C. Beyond some point, incurrence of prevention and appraisal costs is not cost beneficial
- D. Costs in all categories of quality costs may be reduced while improving quality.

**Answer: D**

The optimal level of quality costs traditionally has been deemed to occur where the conformance cost curve intercepts the nonconformance cost curve, which corresponds to the minimum point on the total cost curve. Thus, beyond some point, incurrence of prevention and appraisal costs is not cost beneficial. However, the modern robust quality view is that this relationship does not always hold. Improving quality and reducing costs in each category may be possible if the most efficient prevention methods are applied. For example, selection of a supplier meeting high quality standards regarding defect rates and delivery times may drive down not only failure costs but also the prevention and appraisal costs incurred when supplier performance was less reliable. Thus, conformance costs do not have to continue to increase to obtain additional reductions in nonconformance costs.

**QUESTION: 18**

Management of a company is attempting to build a reputation as a world-class manufacturer of quality products. Which of the following measures would not be used by the firm to measure quality?

- A. The percentage of shipments returned by customers because of poor quality.
- B. The number of parts shipped per day.
- C. The number of defective parts per million.
- D. The percentage of products passing quality tests the first time.

**Answer: B**

The number of parts shipped per day would most likely be used as a measure of the effectiveness and efficiency of shipping procedures, not the quality of the product. This measure does not consider how many of the parts are defective.

**QUESTION: 19**

In Year 2, a manufacturing company instituted a total quality management (TQM) program producing the following report:

## Summary Cost of Quality Report (000s)

	Year 1	Year 2	% Change
Prevention costs	US \$ 200	US \$ 300	+50
Appraisal costs	2100	315	+50
Internal failure costs	190	114	—40
External failure costs	1,200	621	—48
Total quality costs	US \$ 1,800	US \$ 1,350	—25

On the basis of this report, which one of the following statements is most likely true?

- A. An increase in conformance costs resulted in a higher quality product and therefore resulted in a decrease in nonconformance costs.
- B. An increase in inspection costs was solely responsible for the decrease in quality costs.
- C. Quality costs, such as scrap and rework, decreased by 48%.
- D. Quality costs, such as returns and repairs under warranty, decreased by 40%.

**Answer: A**

TQM emphasizes the supplier's relationship with the customer and recognizes that everyone in a process is at some time a customer or supplier of someone else, either within or outside the organization. The costs of quality include costs of conformance and costs of nonconformance. Costs of conformance include prevention costs and appraisal (inspection) costs. Nonconformance costs are composed of internal failure costs and external failure costs, such as lost opportunity. Conformance costs (prevention and appraisal) increased substantially, whereas the nonconformance costs (internal and external failure) decreased. Hence, the increase in conformance costs resulted in a higher-quality product.

**QUESTION: 20**

Quality cost indices are often used to measure and analyze the cost of maintaining a given level of quality. One example of a quality cost index, which uses a direct labor base, is computed as

	May	June
Prevention costs	US \$ 4,000	US \$ 5,000
Appraisal costs	6,000	5,000
Internal failure costs	12,000	15,000
External failure costs	14,000	11,000
Direct labor costs	90,000	100,000

Based upon these costs data, the quality cost index

- A. Decreased four points from May to June.
- B. Was unchanged from May to June.
- C. Increased 10 points from May to June.
- D. Decreased 10 points from May to June.

**Answer:** A

The index for May was [ US \$4,000 + \$6,000 + \$12,000 + \$14,000) – \$90,000], and the index for June was 6% [ US \$5,000 + \$5,000 + \$15,000 + \$-11,000) – \$100,000].

**QUESTION: 21**

Which of the following statements regarding benchmarking is false?

- A. Benchmarking involves continuously evaluating the practices of best-in-class organization and adapting company processes to incorporate the best of these practices.
- B. Benchmarking, in practice, usually involves a company's formation of benchmarking teams.
- C. Benchmarking is an ongoing process that entails quantitative and qualitative measurement of the difference between the company's performance of an activity and the performance by the best in the world or the best in the industry.
- D. The benchmarking organization against which a firm is comparing itself must be a direct competitor.

**Answer:** D

Benchmarking is an ongoing process that entails quantitative and qualitative measurement of the difference between the company's performance of an activity and the performance by a best-in-class organization. The benchmarking organization against which a firm is comparing itself need not be a direct competitor. The important consideration is that the benchmarking organization be an outstanding performer in its industry.

**QUESTION: 22**

An example of an internal nonfinancial benchmark is

- A. The labor rate of comparably skilled employees at a major competitor's plant.
- B. The average actual cost per pound of a specific product at the company's most efficient plant.
- C. A US \$50,000 limit on the cost of employee training programs at each of the company's plants.
- D. The percentage of customer orders delivered on time at the company's most efficient plant.

**Answer: D**

Benchmarking is a continuous evaluation of the practices of the best organizations in their class and the adaptation of processes to reflect the best of these practices. It requires analysis and measurement of key outputs against those of the best organizations. This procedure also involves identifying the underlying key actions and causes that contribute to the performance difference. The percentage of orders delivered on time at the company's most efficient plant is an example of an internal nonfinancial benchmark.

**QUESTION: 23**

Managerial performance may be measured in many ways. For example, an internal nonfinancial measure is

- A. Market share.
- B. Delivery performance.
- C. Customer satisfaction.
- D. Manufacturing lead time.

**Answer: D**

Feedback regarding managerial performance may take the form of financial and nonfinancial measures that may be internally or externally generated. Moreover, different measures have a long-term or short-term emphasis. Examples of internal nonfinancial measures are product quality, new product development time, and manufacturing lead time (cycle time).

**QUESTION: 24**

Which of the following criteria would be most useful to a sales department manager in evaluating the performance of the manager's customer-service group?

- A. The customer is always right.
- B. Customer complaints should be processed promptly.
- C. Employees should maintain a positive attitude when dealing with customers.
- D. All customer inquiries should be answered within 7 days of receipt.

**Answer: D**

A criterion that requires all customer inquiries to be answered within 7 days of receipt permits accurate measurement of performance. The quantitative and specific nature of the appraisal using this standard avoids the vagueness, subjectivity, and personal bias that may afflict other forms of personnel evaluations.

**QUESTION: 25**

Focusing on customers, promoting innovation, learning new philosophies, driving out fear, and providing extensive training are all elements of a major change in organizations. These elements are aimed primarily at

- A. Copying leading organizations to better compete with them.
- B. Focusing on the total quality of products and services.
- C. Being efficient and effective at the same time, in order to indirectly affect profits.
- D. Managing costs of products and services better, in order to become the low-cost provider.

**Answer: B**

TOM is a comprehensive approach to quality. It treats the pursuit of quality as a basic organizational function that is as important as production or marketing. TOM is the continuous pursuit of quality in every aspect of organizational activities through a philosophy of doing it right the first time, employee training and empowerment, promotion of teamwork, improvement of processes, and attention to satisfaction of customers, both internal and external. TOM emphasizes the supplier's relationship with the customer, identifies customer needs, and recognizes that everyone in a process is at some time a customer or supplier of someone else, either inside or outside of the organization.

**QUESTION: 26**

Total quality management in a manufacturing environment is best exemplified by

- A. Identifying and reworking production defects before sale.
- B. Designing the product to minimize defects.
- C. Performing inspections to isolate defects as early as possible.
- D. Making machine adjustments periodically to reduce defects.

**Answer: B**

Total quality management emphasizes quality as a basic organizational function. TOM is the continuous pursuit of quality in every aspect of organizational activities. One of the basic tenets of TOM is doing it right the first time. Thus, errors should be caught and corrected at the source, and quality should be built in (designed in) from the start.

**QUESTION: 27**

One of the main reasons that implementation of a total quality management program works better through the use of teams is

- A. Teams are more efficient and help an organization reduce its staffing.

- B. Employee motivation is always higher for team members than for individual contributors.
- C. Teams are a natural vehicle for sharing ideas, which leads to process improvement.
- D. The use of teams eliminates the need for supervision, thereby allowing a company to reduce staffing.

**Answer: C**

TQM promotes teamwork by modifying or eliminating traditional (and rigid) vertical hierarchies and instead forming flexible groups of specialists. Duality circles, cross-functional teams, and self managed teams are typical formats. Teams are an excellent vehicle for encouraging the sharing of ideas and removing process improvement obstacles. Listed below are costs of quality that a plans to prepare a report that classifies costs, internal failure costs, and extern

<u>Cost Items</u>	<u>Amount</u>
Design reviews	US \$ 275,000
Finished goods returned due to failure	55,000
Freight on replacement finished goods	27,000
Labor inspection during manufacturing	75,000
Lobar inspection of raw materials	32,000
Manufacturing product-testing labor	63,000
Manufacturing rework labor and overhead	150,000
Material used in warranty repairs	68,000
Process engineering	180,000
Product-liability claims	145,000
Product-testing equipment	35,000
Repairs to equipment due to breakdowns	22,000
Scheduled equipment maintenance	90,000
Scrap material	125,000
Training of manufacturing workers	156,000

**QUESTION: 28**

The costs of quality that are incurred in detecting units of product that do not conform to product specifications are referred to as

- A. Preventive costs.
- B. Appraisal costs.
- C. Internal failure costs.
- D. External failure costs.

**Answer: B**

The Categories of quality costs include conformance costs (prevention and appraisal) and nonconformance costs(internal failure and external failure).appraisal costs embrace such activities as statistical quality control programs.inspection,and testing.thus,the cost of detecting nonconforming products is an appraisal cost.listed below are costs of quality that a manufacturing company has incurred throughout its operations.the company plans to prepare a report that classified these costs into the following four categories:preventive costs,appraisal costs,internal failure costs,and external failure costs.

<u>Cost Items</u>	<u>Amount</u>
Design reviews	US \$275,000
Finished goods returned due to failure	55,000
Freight on replacement finished goods	27,000
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Scrap material	125,000
Training of manufacturing workers	156,000

**QUESTION: 29**

The US dollar amount of the costs of quality classified as preventive costs for the manufacturing firm would be

- A. US \$643,000
- B. US \$701,000
- C. US \$736,000
- D. US \$768,000

**Answer: B**

Prevention attempts to avoid defective output, e.g., by employee training, reviews of equipment design, preventive maintenance, and evaluation of suppliers. Accordingly, the preventive costs equal U \$701,000 (U \$275,000 design reviews + U \$180,000 process engineering + U \$90,000 scheduled maintenance + U \$156,000 training).

**QUESTION: 30**

Which of the following is a key to successful total quality management?

- A. Training quality inspectors.
- B. Focusing intensely on the customer.
- C. Creating appropriate hierarchies to increase efficiency.
- D. Establishing a well-defined quality standard, then focusing on meeting it.

**Answer: B**

TQM emphasizes satisfaction of customers, both internal and external. TQM considers the supplier's relationship with the customer, identifies customer needs, and recognizes that everyone in a process is at some time a customer or supplier of someone else, either inside or outside of the organization. Thus, TQM begins with external customer requirements, identifies internal customer-supplier relationships and requirements, and establishes requirements for external suppliers.



**QUESTION: 31**

One of the main reasons total quality management (TQM) can be used as a strategic weapon is that

- A. The cumulative improvement from a company's TQM efforts cannot readily be copied by competitors.
- B. Introducing new products can lure customers away from competitors.
- C. Reduced costs associated with better quality can support higher shareholder dividends.
- D. TQM provides a comprehensive planning process for a business.

**Answer: A**

TQM is a comprehensive approach to quality. It treats the pursuit of quality as a basic organizational function that is as important as production or marketing. Because TQM affects every aspect of the organization's activities, it permeates the organizational culture. Thus, the cumulative effect of TQM's continuous improvement process can attract and hold customers and cannot be duplicated by competitors.

**QUESTION: 32**

Quality control circles are now used all over the world. The circles typically consist of a group of five to ten employees who meet regularly. The primary goal of these circles is

- A. To improve the quality of leadership in the organization.
- B. To tap the creative problem-solving potential of every employee.
- C. To improve communications between employees and managers by providing a formal communication channel.
- D. To allow for the emergence of team leaders who can be targeted for further leadership development.

**Answer: B**

Quality control circles are used to obtain voluntary input from employees to promote problem solving. Potential benefits include lower costs, better employer-employee relations, and greater employee commitment.

**QUESTION: 33**

Which of the following observations concerning quality control is most accurate?

- A. Process quality control is used when examining the quality of goods or services that already exist.

- B. Process quality control is used to prevent defects, and product quality control is used primarily to identify defects after the fact.
- C. Product quality control is designed to balance the marketability of higher quality against the cost of attaining higher quality.
- D. Product quality control is more important than process quality control.

**Answer: B**

Process quality is the effectiveness and efficiency of the organization's internal operations. Product quality is the conformance of the organization's output with customer expectations.

**QUESTION: 34**

If a company is customer-centered, its customers are defined as

- A. Only people external to the company who have purchased something from the company.
- B. Only people internal to the company who directly use its product.
- C. Anyone external to the company and those internal who rely on its product to get their job done.
- D. Everybody external to the company who is currently doing, or may in the future do, business with the company.

**Answer: C**

One of the tenets of TQM is customer orientation, whether the customer is internal or external. An internal customer is a member of the organization who relies on another member's work to accomplish his/her task.

**QUESTION: 35**

A company, which has many branch stores, has decided to use its best-performing store as a benchmark organization for the purpose of analyzing the accuracy and reliability of branch store financial reporting. Which one of the following is the most likely measure to be included in a financial benchmark?

- A. High turnover of employees.
- B. High level of employee participation in setting budgets.
- C. High amount of bad debt write-offs. IT).
- D. High number of suppliers.

**Answer: C**

Internal benchmarking is the application of best practices in one part of the organization (e.g., a high-performing branch store) to its other parts (other branches). This process requires,

among other things, use of quantitative and qualitative measures. A key indicator financial performance measurement is the amount of bad debt write-offs. A high level of bad debt write-offs could indicate fraud, which would compromise the accuracy and reliability of financial reports. Bad debt write-offs may result from recording fictitious sales.

**QUESTION: 36**

Which statement best describes the emphasis of total quality management (TQM)?

- A. Reducing the cost of inspection.
- B. Implementing better statistical quality control techniques.
- C. Doing each job right the first time.
- D. Encouraging cross-functional teamwork.

**Answer: C**

The basic principles of TQM include doing each job right the first time, being customer oriented, committing the company culture to continuous improvement, and building teamwork and employee empowerment.

**QUESTION: 37**

Product-quality-related costs are part of a total quality control program. A product-quality-related cost incurred in detecting individual products that do not conform to specifications is an example of a(n)

- A. Prevention cost.
- B. Appraisal cost.
- C. External failure cost.
- D. Opportunity cost.

**Answer: B**

Quality-related costs can be subdivided into four categories: external failure costs, internal failure costs, prevention costs, and appraisal costs. Appraisal costs embrace such activities as statistical quality control programs, inspection, and testing. Thus, the cost of detecting nonconforming individual products is an appraisal cost.

**QUESTION: 38**

The costs of quality that are incurred in detecting units of product that do not conform to product specifications are referred to as

- A. Prevention costs.
- B. Appraisal costs.
- C. Rework costs.
- D. Failure costs.

**Answer: B**

Appraisal embraces such activities as statistical quality control programs, inspection, and testing. Appraisal costs are those costs such as test equipment maintenance and destructive testing) incurred to detect which products do not conform to specifications.

**QUESTION: 39**

The use of teams in total quality management (TQM) is important because

- A. Well-managed teams can be highly creative and are able to address complex problems better than individuals can.
- B. Teams are quicker to make decisions, thereby helping to reduce cycle time.
- C. Employee motivation is higher for team members than for individual contributors.
- D. The use of teams eliminates the need for supervision, thereby allowing a company to become leaner and more profitable.

**Answer: A**

Teams can use the diverse knowledge and skills of all team members. Employee involvement means training and empowering employees to harness their creativity for problem solving. Quality control circles are used to obtain input from employees and to locate the best perspective on problem solving.

**QUESTION: 40**

A means of limiting production delays caused by equipment breakdown and repair is to

- A. Schedule production based on capacity planning.
- B. Plan maintenance activity based on an analysis of equipment repair work orders.
- C. Pre-authorize equipment maintenance and overtime pay.
- D. Establish a preventive maintenance program for all production equipment.

**Answer: D**

preventive maintenance program will reduce equipment breakdowns and repairs.

**QUESTION: 41**

If a manufacturer has established a limit on the number of defects that are tolerable in the final assembly of its product, which of the following quality control procedures should be employed?

- I. Inspect completed goods for compliance with established tolerances.
- II. Review sales returns for defects not detected during the final inspection process.
- III. Compare materials and machinery specifications with original product designs.
- IV. Establish a quality circle that includes management and subordinates to discuss labor efficiency.

- A. I, III, and I.
- B. II and III only.
- C. I, II, and III.
- D. III and IV only.

**Answer: C**

Quality control procedures may be categorized according to the nature of the costs incurred. An organization incurs appraisal costs to ensure product quality. These costs include the costs of inspection, testing, and statistical quality control programs. An organization also should investigate the causes of sales returns, which represent an external failure cost. Furthermore, the organization should incur certain prevention costs, e.g., by reviewing equipment design and materials requirements.

**QUESTION: 42**

Which statement best describes total quality management (TQM)?

- A. TQM emphasizes reducing the cost of inspection.
- B. TQM emphasizes better statistical quality control techniques.
- C. TQM emphasizes doing each job right the first time.
- D. TQM emphasizes encouraging cross-functional teamwork.

**Answer: C**

TQM establishes quality as an organizational objective and views it as a major component of the organization's service to its customers. It emphasizes employee training and commitment, product/service design and production, and customer service. Ordinarily, the quality of a product or service is as important to customers as cost and timeliness. Superior product quality is not attained merely through more inspection, better statistical quality control, and cross-functional teamwork. Manufacturers must make fundamental changes in the way they produce products and do each job right the first time.

**QUESTION: 43**

Quality cost indices are often used to measure and analyze the cost of maintaining or improving the level of quality. Such indices are computed by dividing the total cost of quality over a given period by some measure of activity during that period (for example, sales dollars). The following cost data are available for a company for the month of March. The company's quality cost index is calculated using total cost of quality divided by sales dollars.

Sales	US \$400,000
Direct materials cost	100,000
Direct labor cost	80,000
Testing and inspection cost	6,400
Scrap and rework cost	16,800
Quality planning cost	2,800
Cost of customer complaints and returns	4,000
The quality cost index for March is	

- A. 7.5%
- B. 6.5%
- C. 22.0%
- D. 5.9%

**Answer: A**

The total cost of quality equals the sum of prevention costs (quality planning), appraisal costs (testing and inspection), internal failure costs (scrap and rework), and external failure costs (customer complaints and returns), or U \$30,000 (\$2,800 + \$6,400 + \$16,800 + \$4,000). The quality cost index equals the total costs of quality divided by sales. Thus, the quality cost index for March is 7.5% (U \$30,000 ÷ U \$400,000).

**QUESTION: 44**

The internal audit activity has undertaken an audit of the shipping and receiving department of a department store chain. The best engagement tool for this purpose most likely is

- A. Competitive benchmarking.
- B. Strategic benchmarking.
- C. Internal benchmarking.
- D. Process benchmarking.

**Answer: D**

Process (function) benchmarking studies operations of organizations with similar processes regardless of industry. Thus, the benchmark need not be a competitor. Or even a similar entity}. This method may introduce new ideas that provide a significant competitive

advantage. The advantage of process benchmarking is that it permits a wider choice of benchmarked organizations. Thus, the best practices for a shipping and receiving function may not be found in the same industry }.

**QUESTION: 45**

Using the balanced scorecard approach, an organization evaluates managerial performance based on

- A. A single ultimate measure of operating results, such as residual income.
- B. Multiple financial and nonfinancial measures.
- C. Multiple nonfinancial measures only.
- D. Multiple financial measures only.

**Answer: B**

The trend in managerial performance evaluation is the balanced scorecard approach. Multiple measures of performance permit a determination as to whether a manager is achieving certain objectives at the expense of others that may be equally or more important. These measures may be financial or nonfinancial and usually include items in four categories: 1) financial; 2) customer; 3) internal business processes; and 4) learning, growth, and innovation.

**QUESTION: 46**

On a balanced scorecard, which of the following is not a customer measure?

- A. Market share.
- B. Economic value added.
- C. Service response time.
- D. Warranty expense.

**Answer: B**

Customer measures include market share and its trend, service response time, delivery performance, warranty returns, expense, complaints, and survey results. Economic value added, or E1 A, is a financial measure.

**QUESTION: 47**

Under the balanced scorecard concept, employee satisfaction and retention are measures used under which of the following perspectives?

- A. Customer.

- B. Internal business.
- C. Learning and growth.
- D. Financial.

**Answer: C**

The balanced scorecard is an accounting report that connects the firm's critical success factors (CSFs) determined in a strategic analysis to measures of its performance. CSFs are financial and nonfinancial measures. For the learning, growth, and innovation perspective, the CSFs may be development of new products, promptness of their introduction, human resource development, morale, and competence of the workforce. Measures of employee satisfaction, retention, and competence may include RD personnel qualifications, hours of training, skill set levels attained, personnel turnover, and personnel complaints and survey results.

**QUESTION: 48**

On a balanced scorecard, which is more of an internal process measure than an external-based measure?

- A. Cycle time.
- B. Profitability.
- C. Customer satisfaction.
- D. Market share.

**Answer: A**

Cycle time is the manufacturing time to complete an order. Thus, cycle time is strictly related to internal processes. Profitability is a combination of internal and external considerations. Customer satisfaction and market share are related to how customers perceive a product and how competitors react.

**QUESTION: 49**

Which one of the following is not a characteristic of an innovative manufacturing company?

- A. Emphasis on continuous improvement.
- B. Responsiveness to the changing manufacturing environment.
- C. Emphasis on existing products.
- D. Improved customer satisfaction through product quality.

**Answer: C**



Innovative companies are customer driven. Because customers demand ever better quality and competitors are attempting to provide that quality, continuous improvement called kaizen by the Japanese) is essential for such companies. Thus, the flaw of innovative products and services must be continuous. Simply emphasizing existing products is not an effective strategy for most organizations.

**QUESTION: 50**

A balanced scorecard is primarily concerned with

- A. Staff.
- B. Structure.
- C. Strategy.
- D. Systems.

**Answer: C**

The scorecard is primarily a tool to assist the organization in describing and clarifying its strategy and then alignment of its performance measures to that strategy.

**QUESTION: 51**

Which of the following is an example of an efficiency measure?

- A. The rate of absenteeism.
- B. The goal of becoming a leading manufacturer.
- C. The number of insurance claims processed per day.
- D. The goal of increasing market share.

**Answer: C**

The number of insurance claims processed per day is a typical measure used in a balanced scorecard. It relates to the critical success factor of productivity. This factor is based on an input-output (efficiency) relationship. An organizational structure is efficient if it facilitates the accomplishment of organizational objectives with minimum resources and fewest unsought consequences. An efficient organizational structure maximizes output for a given amount of input. Thus, an efficiency measure compares input with output. Insurance claims processed per day relates output (claims processed) to input (a day's work).

**QUESTION: 52**

Which of the following is not true about the advantages of adopting ISO 9000 standards?

- A. Adoption of ISO 9000 standards may allow the company to sell products in foreign markets.
- B. ISO registration makes customers more comfortable with the supplier's products and services.
- C. ISO 9000 allows companies to understand who internal customers and users are without sharing private information.
- D. ISO registration may help companies discover internal process and quality improvements.

**Answer: C**

Market pressure is usually the main driving force for companies that adopt ISO 9000 standards. However, many of the companies that register uncover internal process and quality improvement as a result. ISO 9000 forces companies to share information, which leads to a better understanding of who internal customers and users are.

**QUESTION: 53**

Why have many European Union countries not adopted ISO 14000 standards?

- A. Adhering to ISO 14000 standards will not reduce monitoring and inspection by regulatory agencies.
- B. Individual European Union countries' standards are typically more strict than ISO 14000 standards.
- C. Regulators are permitted to use voluntary audits as a basis for punitive action.
- D. ISO 14000 standards will not make it easier to do business across borders.

**Answer: B**

Many European countries already have environmental systems in place, and many individual countries' standards are typically more strict than the ISO 14000 standards.

**QUESTION: 54**

Which of the following is not required when ISO 9000 standards are adopted?

- A. Organization of a quality management system.
- B. Creation of an internal audit system.
- C. Consistent high quality products.
- D. On-site inspections by a registrar.

**Answer: C**

ISO 9000 is a set of generic standards for establishing and maintaining a quality system within a company. The standards provide no basis for judging the quality of the end product.

The marketplace will make this determination on its own. The objective of ISO 9000 standards is to ensure consistent quality.

**QUESTION: 55**

Which of the following statements is not true regarding ISO 9000 standards?

- A. Compliance with the standards is voluntary.
- B. The ISO 9000 standards are revised every 5 years to account for technological and market developments.
- C. The objective of ISO 9000 standards is to ensure high quality products and services.
- D. ISO 9000 is a set of generic standards for establishing and maintaining a quality system within a company.

**Answer: C**

The objective of ISO 9000 standards is to ensure consistent quality even if the quality is poor. The market will determine the quality of the end result.

**QUESTION: 56**

What ensures that a company is complying with the documented quality management system QMS: procedures and ISO 9000 standards?

- A. The internal audit.
- B. The registrar.
- C. On-site inspections by an external auditor.
- D. Management commitment.

**Answer: A**

An important requirement of the ISO 9000 standards is the internal audit system. Internal audits assure that the company is complying with the documented QMS procedures and ISO 9000 standards.

**QUESTION: 57**

Which of the following is a major element of the ISO 9000:2008 quality management system standards?

- A. The principle that improved employee satisfaction will lead to increased productivity.
- B. The attitude and actions of the board and management regarding the significance of control within the organization.

- C. The assessment of the risk that objectives are not achieved.  
 D. A requirement for organizations to monitor information on customer satisfaction as a measure of performance.

**Answer: D**

ISO 9001:2008, Quality Management Systems— Requirements, is the standard that provides a model for quality assurance programs. Organizations are required to monitor information on customer satisfaction as a measure of performance.

**QUESTION: 58**

What coefficient of correlation results from the following data?

$\bar{X}$	$\bar{Y}$
1	10
2	8
3	6
4	4
5	2

- A. 0  
 B. -1  
 C. +1  
 D. Cannot be determined from the data given.

**Answer: B**

The coefficient of correlation in standard notation,  $r$ ) measures the strength of the linear relationship. The magnitude of  $r$  is independent of the scales of measurement of  $X$  and  $Y$ . Its range is -1.0 to 1.0. A value of -1.0 indicates a perfectly inverse linear relationship between  $X$  and  $Y$ . A value of zero indicates no linear relationship between  $X$  and  $Y$ . A value of +1.0 indicates a perfectly direct relationship between  $X$  and  $Y$ . As  $X$  increases by 1, consistently decreases by 2. Hence, a perfectly inverse relationship exists, and  $r$  must be equal to -1.0.

**QUESTION: 59**

In regression analysis, which of the following correlation coefficients represents the strongest relationship between the independent and dependent variables?

- A. 1.03  
 B. -.02  
 C. -.89  
 D. .75

**Answer: C**

Because the range of values is between -1.0 and 1.0, -.89 suggests a very strong inverse relationship between the independent and dependent variables. A value of -1.0 signifies a perfect inverse relationship, and a value of 1.0 signifies a perfect direct relationship.

**QUESTION: 60**

The internal auditor of a bank has developed a multiple regression model which has been used for a number of years to estimate the amount of interest income from commercial loans. During the current year, the auditor applies the model and discovers that the  $r^2$  value has decreased dramatically, but the model otherwise seems to be working okay. Which of the following conclusions is justified by the change?

- A. Changing to a cross-sectional regression analysis should cause  $r^2$  to increase.
- B. Regression analysis is no longer an appropriate technique to estimate interest income.
- C. Some new factors not included in the model are causing interest income to change.
- D. A linear regression analysis would increase the model's reliability.

**Answer: C**

The coefficient of determination ( $r^2$ ) is the amount of variation in the dependent variable (interest income) that is explained by the independent variables. In this case, less of the change in interest income is explained by the model. Thus, some other factor must be causing interest income to change. This change merits audit investigation. In preparing the annual profit plan for the coming year, Wilkens Company wants to determine the cost behavior pattern of the maintenance costs. Wilkens has decided to use linear regression by employing the equation  $y = a + bx$  for maintenance costs. The prior year's data regarding maintenance hours and costs, and the results of the regression analysis, are given below and in the opposite column.

**QUESTION: 61**

In the standard regression equation  $y = a + bx$ , how is the letter  $b$  best described?

- A. Independent Variable
- B. Dependent Variable
- C. Constant coefficient
- D. Variable coefficient

**Answer: D**

In the standard regression equation,  $b$  represents the variable coefficient. For example, in a cost determination regression,  $y$  equals total costs,  $b$  is the variable cost per unit,  $x$  is the number of units produced, and  $a$  is fixed cost. In preparing the annual profit plan for the coming year, Wilkens Company wants to determine the cost behavior pattern of the maintenance costs.

Wilkens has decided to use linear regression by employing the equation  $y = a + bx$  for maintenance costs. The prior year's data regarding maintenance hours and costs, and the results of the regression analysis, are given below and in the opposite column.

**QUESTION: 62**

How is the letter x in the standard regression equation best described?

- A. Independent Variable
- B. Dependent Variable
- C. Constant coefficient
- D. Coefficient of determination

**Answer: A**

The letters x in the standard regression equation is the independent variable. For example, in a regression to determine the total cost of production, equal units produced. In preparing the annual profit plan for the coming year, Wilkens Company wants to determine the cost behavior pattern of the maintenance costs. Wilkens has decided to use linear regression by employing the equation  $y = a + bx$  for maintenance costs. The prior year's data regarding maintenance hours and costs, and the results of the regression analysis, are given below and in the opposite column.

**QUESTION: 63**

Based upon the data derived from the regression analysis, 420 maintenance hours in a month would mean the maintenance costs (rounded to the nearest US dollar) would be budgeted at

- A. U \$3,780
- B. U \$3,600
- C. U \$3,790
- D. U \$3,746

**Answer: D**

Substituting the given data into the regression equation results in a budgeted cost of US \$3,746 (rounded to the nearest US dollar).

$$y = a + bx$$

$$y = 684.65 + 7.2884(420)$$

$$y = \text{us } \$3,746$$

In preparing the annual profit plan for the coming year, Wilkens Company wants to determine the cost behavior pattern of the maintenance costs. Wilkens has decided to use linear regression by employing the equation  $y = a + bx$  for maintenance costs. The prior year's data regarding maintenance hours and costs, and the results of the regression analysis, are given below and in the opposite column.

		Hours of Activity	Maintenance Costs
		480	US \$ 4,200
	January	320	3,000
	February	400	3,600
	March	300	2,820
	April	500	4,350
	May	310	2,960
Average cost per hour	US \$9.00	320	3,030
$a$	684.65	520	4,470
$b$	7.2884	490	4,260
Standard error of $a$	49.515	470	4,050
Standard error of $b$	.12126	350	3,300
Standard error of the estimate	34.469	340	3,160
$r^2$	.99724	4,800	US \$43,200
	Sum		
	Average	400	US \$ 3,600

**QUESTION: 64**

What is the percentage of the total variance that can be explained by the regression

- A. 99.724°1°
- B. 69.613°1°
- C. 80.982%
- D. 99.862%

**Answer: A**

The coefficient of determination ( $r^2$ ) measures the percentage of the total variance in cost that can be explained by the regression equation. If the coefficient of determination is .99724, 99.724% of the variance is explained by the regression equation. Thus, the values in the regression equation explain virtually the entire amount of total cost.

**QUESTION: 65**

An internal auditor for a large automotive parts retailer wishes to perform a risk analysis and wants to use an appropriate statistical tool to help identify stores that would be out of line compared to the majority of stores. The most appropriate statistical tool to use is

- A. Linear time series analysis.
- B. Cross-sectional regression analysis.
- C. Cross tabulations with chi-square analysis of significance.
- D. Time series multiple regression analysis to identify changes in individual stores overtime.

**Answer: B**

Time series data pertain to a given entity over a number of prior time periods. Cross sectional data, however, pertain to different entities for a given time period or at a given time. Thus, cross-sectional regression analysis is the most appropriate statistical tool because it compares attributes of all stores' operating statistics at one moment in time.

**QUESTION: 66**

A division uses a regression in which monthly advertising expenditures are used to predict monthly product sales both in millions of US dollars). The results show a regression coefficient for the independent variable equal to 0.8. This coefficient value indicates that

- A. The average monthly advertising expenditure in the sample is US \$800,000.
- B. When monthly advertising is at its average level, product sales will be US \$800,000.
- C. On average, every additional dollar of advertising results in US \$.80 of additional sales.
- D. Advertising is not a good predictor of sales because the coefficient is so small.

**Answer: C**

The regression coefficient represents the change in the dependent variable corresponding to a unit change in the independent variable. Thus, it is the slope of the regression line.

**QUESTION: 67**

Quality control programs employ many tools for problem definition and analysis. A scatter diagram is one of these tools. The objective of a scatter diagram is to

- A. Display a population of items for analysis.
- B. Show frequency distribution in graphic form.
- C. Divide a universe of data into homogeneous groups.
- D. Show the vital trend and separate trivial items.

**Answer: A**

The objective of a scatter diagram is to demonstrate correlations. Each observation is represented by a dot on a graph corresponding to a particular value of X (the independent variable) and Y (the dependent variable).

**QUESTION: 68**

Violation of which assumption underlying regression analysis is prevalent in time series analysis?

- A. Variance of error term is constant.



- B. Error terms are independent.
- C. Distribution of error terms is normal.
- D. Expected value of error term equals zero.

**Answer: B**

Time series analysis is a regression model in which the independent variable is time. In time series analysis, the value of the next time period is frequently dependent on the value of the time period before that. Hence, the error terms are usually correlated or dependent on the prior period; i.e., they are characterized by autocorrelation (serial correlation).

**QUESTION: 69**

The moving-average method of forecasting

- A. Is a cross-sectional forecasting method.
- B. Regresses the variable of interest on a related variable to develop a forecast.
- C. Derives final forecasts by adjusting the initial forecast based on the smoothing constant.
- D. Includes each new observation in the average as it becomes available and discards the oldest observation.

**Answer: D**

The simple moving-average method is a smoothing technique that uses the experience of the past  $N$  periods (through time period  $t$ ) to forecast a value for the next period. Thus, the average includes each new observation and discards the oldest observation. The forecast formula for the next period (for time period  $t+1$ ) is the sum of the last  $N$  observations divided by  $N$ .

**QUESTION: 70**

As part of a risk analysis, an auditor wishes to forecast the percentage growth in next month's sales for a particular plant using the past 30 months' sales results. Significant changes in the organization affecting sales volumes were made within the last 9 months. The most effective analysis technique to use would be

- A. Unweighted moving average.
- B. Exponential smoothing.
- C. Queuing theory.
- D. Linear regression analysis.

**Answer: B**

Under exponential smoothing, each forecast equals the sum of the last observation times the smoothing constant, plus the last forecast times one minus the constant. Thus, exponential means that greater weight is placed on the most recent data, with the weights of all data falling off exponentially as the data age. This feature is important because of the organizational changes that affected sales volume.

**QUESTION: 71**

The average labor cost per unit for the first batch produced by a new process is US \$120. The cumulative average labor cost after the second batch is US \$72 per product. Using a batch size of 100 and assuming the learning curve continues, the total labor cost of four batches will be

- A. US \$4,320
- B. US \$10,368
- C. US \$2,592
- D. US \$17,280

**Answer: D**

The learning curve reflects the increased rate at which people perform tasks as they gain experience. The time required to perform a given task becomes progressively shorter. Ordinarily, the curve is expressed in a percentage of reduced time to complete a task for each doubling of cumulative production. One common assumption in a learning curve model is that the cumulative average time and labor cost) per unit is reduced by a certain percentage each time production doubles. Given a US \$120 cost per unit for the first 100 units and a US \$72 cost per unit when cumulative production doubled to 200 units, the learning curve percentage must be 60% (US \$72 - \$120). If production is again doubled to 400 units (four batches), the average unit labor cost should be US \$43.20 ( $72 \times 60\%$ ). Hence, total labor cost for 400 units is estimated to be US \$17,280 ( $400 \times \$43.20$ ).

**QUESTION: 72**

A plumbing company, a wholesale distributor, supplies plumbing contractors and retailers throughout the Northeast on a next-day delivery basis. The company has a centrally located warehouse to accept receipts of plumbing supplies. The warehouse has a single dock to accept and unload railroad freight cars during the night. It takes 5 hours to unload each freight car. The company's prior records indicate that the number of freight cars that arrive in the course of a night range from zero to five or more, with no indicated pattern of arrivals. If more than two freight cars arrive on the same night, some freight must be held until the next day for unloading. The company wants to estimate the wait time when more than two freight cars arrive in the same night. The appropriate technique to analyze the arrival of freight cars is

- A. Integer programming.
- B. Linear programming.
- C. Monte Carlo simulation.
- D. Regression analysis.

**Answer: C**

The Monte Carlo simulation method is often used to generate the individual values for a random variable. The performance of a quantitative model under uncertainty may be investigated by randomly selecting values for each variable in the model (based on the probability distribution of each variable) and then calculating the value of the solution. If this process is performed many times, the distribution of results from the model will be obtained.

**QUESTION: 73**

Through the use of decision models, managers thoroughly analyze many alternatives and decide on the best alternative for the company. Often the actual results achieved from a particular decision are not what was expected when the decision was made. In addition, an alternative that was not selected would have actually been the best decision for the company. The appropriate technique to analyze the alternatives by using expected inputs and altering them before a decision is made is

- A. Expected value analysis.
- B. Linear programming.
- C. Program evaluation review technique (PERT).
- D. Sensitivity analysis.

**Answer: D**

Sensitivity modeling can be used to determine the outcome of a variety of decisions. A trial-and-error method may be adopted, usually in a computer model, to calculate the sensitivity of the solution (variability of outcomes) to changes in a variable.

**QUESTION: 74**

A firm is attempting to estimate the reserves for doubtful accounts. The probabilities of these doubtful accounts follow a transition process over time. They evolve from their starting value to a changed value. As such, the most effective technique to analyze the problem is

- A. Markov chain analysis.
- B. Econometric theory.
- C. Monte Carlo analysis.
- D. Dynamic programming.

**Answer: A**

A Markov chain is a series of events in which the probability of an event depends on the immediately preceding event. An example is the game of blackjack in which the probability of certain cards being dealt is dependent upon what cards have already been dealt. In the analysis of bad debts, preceding events, such as collections, credit policy changes, and write offs, affect the probabilities of future losses.

**QUESTION: 75**

A. company has several departments that conduct technical studies and prepare reports for clients. Recently, there have been long delays in having these reports copied at the company's centralized copy center because of the dramatic increase in business. !Management is considering decentralizing copy services to reduce the turnaround and provide clients with timely reports. An appropriate technique for minimizing turnaround time and the cost of providing copy services is

- A. Queuing theory.
- B. Linear programming.
- C. Regression analysis.
- D. Game theory.

**Answer: A**

Two basic costs are involved in queuing (waiting-line) models: 1) the cost of providing service (including facility costs and operating costs), and 2) the cost of idle resources waiting in line. The latter II may be a direct cost if paid employees are waiting, or an opportunity cost in the case of waiting customers. The objective of queuing theory is to minimize the total cost of the system, including both service and waiting costs, for a given rate of arrivals. This minimization occurs at the point at which cost of waiting is balanced by the cost of providing service. This company wishes to reduce the total of waiting costs (turnaround time) and the cost of copy services.

**QUESTION: 76**

Queuing models are concerned with balancing the cost of waiting in the queue with the

- A. Cost of providing service.
- B. Number of customers in the queue.
- C. Average waiting time in the queue.
- D. Usage rate for the service being rendered.

**Answer: A**

Queuing (waiting-line) models minimize, for a given rate of arrivals, the sum of 1) the cost of providing service (including facility costs and operating costs) and 2) the cost of idle resources waiting in line. The latter may be a direct cost, if paid employees are waiting, or an opportunity cost in the case of waiting customers. This minimization occurs at the point where the cost of waiting is balanced by the cost of providing service.

**QUESTION: 77**

The operating condition that can-or-mot be identified by using a queuing model is the

- A. Average percentage of time that a service facility is idle.
- B. Probability of a specified number of units in the queue.
- C. Actual amount of time each unit spends in the queue.
- D. Average number of units in the system and the mean length of the queue.

**Answer: C**

Queuing models determine the operating characteristics of a waiting line: the probability that no units are in the system, the average units in the line, the average units in the system, the average time a unit waits, the average time a unit is in the system, the probability that a unit must wait, and the probability of a given number of units in the system. However, the actual time spent in the queue cannot be determined from the model.

**QUESTION: 78**

A bank has changed from a system in which lines are formed in front of each teller - to a one-line, multiple-server system. When a teller is free, the person at the head of the line goes to that teller. Implementing the new system will

- A. Decrease the bank's wage expenses because the new system uses fewer tellers.
- B. Decrease time customers spend in the line.
- C. Increase accuracy in teller reconciliations at the end of the day because fewer customers are served by each teller
- D. Improve on-the-job training for tellers because each will perform different duties.

**Answer: B**

When all customers must wait in a single queue, a decrease in waiting time is possible given multiple servers. An added effect is to increase customer satisfaction.

**QUESTION: 79**

The drive-through service at a fast-food restaurant consists of driving up to place an order, advancing to a window to pay for the order, and then advancing to another window to receive the items ordered. This type of waiting-line system is

- A. Single channel, single phase.
- B. Single channel, multiple phase.
- C. Multiple channel, single phase.
- D. Multiple channel, multiple phase.

**Answer: B**

The drive-through represents a single queue (channel). Because this waiting line has three services in series, it may be said to be multiple phase. Another example is the typical factory assembly line. This terminology (channel, phase), however, is not used by all writers on queuing theory.

**QUESTION: 80**

A post office serves customers in a single line at one service window. During peak periods, the rate of arrivals has a Poisson distribution with an average of 100 customers per hour and service times that are exponentially distributed with an average of 0 seconds per customer. From this, one can conclude that the

- A. Queue will expand to infinity.
- B. Server will be idle one-sixth of the time.
- C. Average rate is 100 customers per hour.
- D. Average customer waiting time is minutes.

**Answer: A**

One hundred customers arrive in line per hour and only 60 are serviced per hour. Accordingly, the queue will expand to infinity during peak periods.

**QUESTION: 81**

Only two companies manufacture Product A. The finished product is identical regardless of which company manufactures it. The cost to manufacture Product A is US \$1, and the selling price is US \$2. One company considers reducing the price to achieve 100% market share but fears the other company will respond by further reducing the price. Such a scenario would involve a

- A. No-win strategy.
- B. Dual-win strategy.

- C. One win-one lose strategy.
- D. Neutral strategy.

**Answer: A**

If both firms reduce the selling price of Product A, neither will gain sales and the resultant price war will cause both firms to earn lower profits. This outcome is inevitable when reduced profit margins do not result in a significant increase in sales. The effect is a no-win strategy. A bank has two drive-in lanes to serve customers: one attached to the bank itself and one on an island. One teller serves both stations. The bank is interested in determining the average waiting times of customers and has developed a model based on random numbers. The two key factors are the time between successive car arrivals and the time customers wait in line. Assume that the analysis begins with cars just arriving at both service windows, both requiring 3 minutes of service time. Car 1 is the attached window attached to the bank unless that window has more cars waiting than the island window. The lone teller will always serve the car that arrived first. If two cars arrive simultaneously, the one at the attached window will be served before the one at the island.

**QUESTION: 82**

The arrival time follows which probability distribution?

- A. Binomial
- B. Chi-Square
- C. Poisson
- D. Exponential

**Answer: C**

Queuing models assume that arrivals follow a Poisson process: the events (arrivals) are independent, any number of events must be possible in the interval of time, the probability of an event is proportional to the length of the interval, and the probability of more than one event is negligible if the interval is sufficiently small. If  $\lambda$  is the average number of events in a given interval,  $k$  is the number of events, and  $e$  is the natural logarithm (2.71828...), the probability of  $k$  is,

$$P(K) = \frac{\lambda^k e^{-\lambda}}{k!}$$

A bank has two drive-in lanes to serve customers: one attached to the bank itself and one on an island. One teller serves both stations. The bank is interested in determining the average waiting times of customers and has developed a model based on random numbers. The two key factors are the time between successive car arrivals and the time customers wait in line. Assume that the analysis begins with cars just arriving at both service windows, both requiring 3 minutes of service time. Car 1 is the attached window attached to the bank unless that window has more cars waiting than the island window. The lone teller will always serve the car that arrived first. If two cars arrive simultaneously, the one at the attached window will be served before the one at the island.

**QUESTION: 83**

The time that car 3 will have to wait to be serviced

- A. 0-2 minutes.
- B. 3 minutes.
- C. 4 minutes.
- D. 5+ minutes.

**Answer: C**

Car 1 is at the attached window and will require minutes to service. Car 2 must wait for car 1 to be serviced (minutes •fr the queue + minutes to be serviced = 6 minutes). Car arrived at the attached window minutes after cars 1 and . It must wait 1 minute for car 1 to be serviced and minutes for car to be serviced, a waiting time of 4 minutes. A bank has two drive-in lanes to serve customers: one attached to the bank itself and one on an island. One teller serves both stations. The bank is interested in determining the average waiting times of customers and has developed a model based on random numbers. The two key factors are the time between successive car arrivals and the time customers wait in line. Assume that the analysis begins with cars just arriving at both service windows, both requiring 3 minutes of service time. Car 1 is the attached window attached to the bank unless that window has more cars waiting than the island window. The lone teller will always serve the car that arrived first. If two cars arrive simultaneously, the one at the attached window will be served before the one at the island.

**QUESTION: 84**

The time that car 4 will have to wait to be

- A. 0-2 minutes.
- B. 3 minutes.
- C. 4 minutes.
- D. 5+ minutes.

**Answer: C**

Car 4 arrives at the just-vacated island window 4 minutes after car . It must wait 4 minutes for car to be serviced.

**QUESTION: 85**

The decision rule that selects the strategy with the highest utility payoff if the worst state of nature occurs is the



- A. Minimize regret rule.
- B. Maximize utility rule.
- C. Maximin rule.
- D. Maxi max rule.

**Answer: C**

The maximin rule determines the minimum payoff for each decision and then chooses the decision with the maximum minimum payoff. It is a conservative criterion adopted by risk-averse players, that is, those for whom the disutility of a loss exceeds the utility of an equal gain.

**QUESTION: 86**

Your company " has decided to enter the European market with one of its products and is now considering three advertising strategies. This market currently belongs to Company X. Company X is aware that your company is entering the market and is itself considering steps to protect its market. An analyst for your company has identified three strategies Company X might develop and has shown the payoffs for each in the tables below. The analyst has formulated this

- A. Zero-sum game.
- B. Cooperative game.
- C. Prisoner's dilemma.
- D. Game against nature.

**Answer: A**

Game theory is a mathematical approach to decision making when confronted with an enemy or competitor. Games are classified according to the number of players and the algebraic sum of the payoffs. In a two-player game, if the payoff is given by the loser to the winner, the algebraic sum is zero, and the game is a zero-sum game. However, if it is possible for both players to profit, the game is a positive sum game. In this situation, the sum of the payoffs for each combination of strategies is zero. For example, if X takes no action and Y chooses limited advertising, X's payoff is -1 and Y's is 1. A bank plans to open a branch in one of five locations (labeled L1, L2, L3, L4, L5). Demand for bank services may be high, medium, or low at each of these locations. Profits for each location-demand combination are presented in the payoff matrix.

**QUESTION: 87**

If the bank uses the maximin criterion for selecting the location of the branch, it will select

- A. L1.
- B. L2.
- C. L3.
- D. L4.

**Answer: D**

Under the maximax criterion, the decision maker selects the choice that maximizes the maximum profit. The maximum profits for the five locations are

Location	L1	L2	L3	L4	L5
Maximum Profit	15	21	17	26	29

The location with the greatest potential profit is L5.

A bank plans to open a branch in one of five locations labeled L1, L2, L3, L4, L5). Demand for bank services may be high, medium, or low at each of these locations. Profits for each location-demand combination are presented in the payoff matrix.

Payoff Matrix		L1	L2	L3	L4	L5
Location	Demand:					
	High	15	21	17	26	29
	Medium	12	8	14	10	4
	Low	7	-2	4	-3	-6

**QUESTION: 88**

If the bank uses the minimax regret criterion for selecting the location of the branch, it will select

- A. L1.
- B. L2.
- C. L3.
- D. L4.

**Answer: B**

Under the minimax regret criterion, the decision maker selects the choice that minimizes the maximum regret (opportunity cost). The maximum regret for each location is determined from the opportunity loss matrix. The maximum regret for each location is the highest number in each column as indicated below.

Location	L1	L2	L3	L4	L5
Maximum Regret	14	9	12	10	13

The location with the minimum regret is L2. If demand is low, L2 has a payoff -2, whereas L1 has a payoff of 7. A bank plans to open a branch in one of five locations labeled L1, L2, L3, L4, L5). Demand for bank services may be high, medium, or low at each of these locations. Profits for each location-demand combination are presented in the payoff matrix.

Payoff Matrix					
Location	L1	L2	L3	L4	L5
Demand:					
High	15	21	17	26	29
Medium	12	8	14	10	4
Low	7	-2	4	-3	-6

**QUESTION: 89**

If, in addition to the estimated profits, management of the bank assesses the probabilities of high, medium, and low demands to be 0.3, 0.4, and 0.3 respectively, what is the expected opportunity loss from selecting location of L4?

- A. 5.50
- B. 7.90
- C. 7.50
- D. 5.00

**Answer: A**

The opportunity loss matrix is as follow:

Location	L1	L2	L3	L4	L5
Demand: High	$14 = 29 - 15$	$8 = 29 - 21$	$12 = 29 - 17$	$3 = 29 - 26$	$0 = 29 - 29$
Medium	$2 = 14 - 12$	$6 = 14 - 8$	$0 = 14 - 14$	$4 = 14 - 10$	$10 = 14 - 4$
Low	$0 = 7 - 7$	$9 = 7 - (-2)$	$3 = 7 - 4$	$10 = 7 - (-3)$	$13 = 7 - (-6)$

The expected opportunity loss from selecting location L4 is 5.50  $[(3 \times 0.3) + (4 \times 0.4) + (10 \times 0.3)]$ .

**QUESTION: 90**

During the past few years, Wilder Company has experienced the following average number of power outages:

Number per Month	Number of Months
0	3
1	2
2	4
3	3
	<u>12</u>

Each power outage results in out-of-pocket costs of U \$300. For U \$1,000 per month, At US \$800 can lease generator to provide power during outages. If Wilder leases a generator in the coming year, the estimated savings or additional expense) for the year will be

- A. U \$ 15,200)
- B. US \$ 1,267)
- C. U \$3,200
- D. U \$7,200

**Answer: C**

Each outage costs US \$800, but this experience can be avoided by paying US \$1,000 per month (US \$12,000 for the year). The expected-value approach uses the probability distribution derived from past experience to determine the average expected outages per month.

$$\begin{array}{rcl}
 3 + 12 \times 0 & = & 0.0 \\
 2 + 12 \times 1 & = & 0.16667 \\
 4 + 12 \times 2 & = & 0.66667 \\
 3 + 12 \times 3 & = & 0.75000 \\
 & & \underline{1.58334}
 \end{array}$$

The company can expect to have, on average, 1.58334 outages per month. At US \$800 per outage, the expected costs is US \$1,266.67. Thus, paying US \$1,000 to avoid an expense of US \$1,266.67 saves US \$266.67 per month, or US \$3,200 per year.

**QUESTION: 91**

Philip enterprises, distributor of compact disks (CDS), is developing its budgeted cost of goods sold for 1998. Philip has developed the following range of sales estimates and associated probabilities for the year:

<u>Sales Estimate</u>	<u>Probability</u>
US \$ 60,000	25%
85,000	40
100,000	35

Philip's cost of goods sold averages 80% of sales. What is the expected value of Philip's 1998 budgeted cost of goods sold?

- A. US \$85,000
- B. US \$84,000
- C. US \$68,000
- D. US \$67,200

**Answer: D**

The expected value is calculated by weighting each sales estimate by the probability of its occurrence. Consequently, the expected value of sales is US \$84,000 [(\$60,000 .25) + (\$85,000 .40) + (\$100,000 .35)]. Cost of goods sold is therefore US \$67,200 (80% of \$84,000).

**QUESTION: 92**

The expected value of perfect information is the

- A. Same as the expected profit under certainty.

- B. Sum of the conditional profit (loss) for the best event of each act times the probability of each event occurring.
- C. Difference between the expected profit under certainty and the expected opportunity loss.
- D. Difference between the expected profit under certainty and the expected monetary value of the best act under uncertainty

**Answer: D**

Perfect information permits certainty that a future state of nature will occur. The expected value of perfect information determines the maximum amount a decision maker is willing to pay for information. It is the difference between the expected value without perfect information, that is, the expected value of the best action under uncertainty and the expected value under certainty. Under certainty, a decision maker knows in each case which state of nature will occur and can act accordingly.

**QUESTION: 93**

A chief executive officer (CEO) believes that a major competitor may be planning a new campaign. The CEO sends a questionnaire to key personnel asking for original thinking concerning what the new campaign may be. The CEO selects the best possibilities then sends another questionnaire asking for the most likely option. The process employed by the CEO is called the

- A. Least squares technique.
- B. Delphi technique.
- C. Maximum likelihood technique.
- D. Optimizing of expected payoffs.

**Answer: B**

The Delphi technique is a forecasting or decision-making approach that attempts to avoid groupthink (the tendency of individuals to conform to what they perceive to be the consensus). The technique allows only written, anonymous communication among group members. Each member takes a position on the problem at hand. A summary of these positions is communicated to each member. The process is repeated for several iterations as the members move toward a consensus. Thus, the Delphi technique is a qualitative, not quantitative, technique. The College Honor Society sells hot pretzels at the home football games. The pretzels are sold for US \$1.00 each, and the cost per pretzel is US \$.30. Any unsold pretzels are discarded because they will be stale before the next home game. 95. The estimated demand for pretzel at the next home football game.

**QUESTION: 94**

The estimated demand for pretzels at the next home football game using an expected value approach is

- A. 4,000 pretzels.
- B. 4,400 pretzels.
- C. 5,000 pretzels.
- D. 6,000 pretzels.

**Answer: B**

The calculation using an expected value approach weights each possible sales volume by its probability. Thus, the estimated demand is 4,400 pretzels.

<u>Volume</u>		<u>Probability</u>		<u>Result</u>
2,000	x	.10	=	200
3,000	x	.15	=	450
4,000	x	.20	=	800
5,000	x	.35	=	1,750
6,000	x	.20	=	1,200
Expected value				<u>4,400</u>

The College Honor Society sells hot pretzels at the home football games. The pretzels are sold for US \$1.00 each, and the cost per pretzel is U \$.30. Any unsold pretzels are discarded because they will be stale before the next home game. 95. The estimated demand for pretzel at the next home football game. The frequency distribution of the demand for pretzels pe game is presented as follows.

<u>Unit Sales Volume</u>	<u>Probability</u>
2,000 pretzels	.10
3,000 pretzels	.15
4,000 pretzels	.20
5,000 pretzels	.35
6,000 pretzels	.20

**QUESTION: 95**

The estimated demand for pretzels at the next home football game using a deterministic approach based on the most likely outcome is

- A. 4,000 pretzels.
- B. 4,400 pretzels.
- C. 5,000 pretzels.
- D. 6,000 pretzels.

**Answer: C**

A deterministic approach assumes that a value is known with certainty. If that value is deemed to be the most likely outcome, assumed demand will be 5,000 pretzels, the volume with the highest probability (35%). A beverage stand can sell either soft drinks or coffee on any given day. If the stand sells soft drinks and the weather is hot, it will make US \$2,600; if the weather is cold, the profit will be US \$1,000. If the stand sells coffee and the weather is

hot, it will make US \$1,900; if the weather is cold, the profit will be US \$2,000. The probability of cold weather on a given day at this time is 60%.

**QUESTION: 96**

The expected payoff if the vendor has perfect information is

- A. US \$3,900
- B. US \$2,200
- C. US \$1,360
- D. US \$1,960

**Answer: B**

The vendor would like to sell coffee on cold days (US \$2,000) and soft drinks on hot days (US \$2,500). Hot days are expected 40% of the time. Hence, the probability is 40% of making US \$2,500 by selling soft drinks. The chance of making US \$2,000 by selling coffee is 60%. The payoff equation is:

$$.4 \text{ US } \$2,600 + .6 \text{ US } \$2,000 = \text{US } \$2,200$$

A beverage stand can sell either soft drinks or coffee on any given day. If the stand sells soft drinks and the weather is hot, it will make US \$2,500; if the weather is cold, the profit will be US \$1,000. If the stand sells coffee and the weather is hot, it will make US \$1,900; if the weather is cold, the profit will be US \$2,000. The probability of cold weather on a given day at this time is 60%.

**QUESTION: 97**

If the probability of hot weather, given a hot weather forecast, is 50%, how much would the vendor be willing to pay for the forecast?

- A. US \$600
- B. US \$300
- C. US \$1,000
- D. US \$500

**Answer: B**

If the weather is hot and coffee is served, the vendor earns US \$1,900. If the vendor knows the weather will be hot, s/he would sell soft drinks and make US \$2,500, a US \$600 increase. Thus, the vendor should be willing to pay up to US \$600 for perfect information regarding hot weather. However, if the forecasts are only 50% accurate, the information is not perfect. Accordingly, the vendor should be willing to pay only US \$300 (the US \$600 potential increase in profits 50%) for the sometimes accurate forecasts.

**QUESTION: 98**

An audit manager has just returned from an executive training program and has suggested that the audit department develop a mathematical model to help identify factors that may be causing changes in the cost of production. According to the manager, the model should recognize that the company currently has three separate production cost centers. Which of the following approaches would best provide the analysis suggested by the audit manager?

- A. Develop a classical variables sampling estimate of cost of production per department, with the sample stratified by the dollar value of each product produced.
- B. Develop a -gear ratio analysis of the cost of production compared to the cost of raw inventory across the three departments.
- C. Develop a multiple regression analysis of production costs, including such variables as raw material inventory costs, number of employees in the department, and overtime pay.
- D. Develop a linear regression analysis relating the cost of production to the cost of goods sold.

**Answer: C**

Regression analysis extends correlation to find an equation for the linear relationship among variables. The behavior of a dependent variable, such as cost of production, is explained in terms of one or more independent variables (for example, raw material costs, employees, overtime). Thus, multiple regression analysis determines functional relationships among quantitative variables.

**QUESTION: 99**

The following data on variables x and y was collected from June to October:

	<u>June</u>	<u>July</u>	<u>August</u>	<u>September</u>	<u>October</u>
x	24	31	19	15	22
y	104	76	124	140	112

The correlation coefficient between variables x and y is nearest to

- A. 1.00
- B. -1.00
- C. 0.50
- D. 0.00

**Answer: B**

A correlation coefficient of -1.00 describes a perfect inverse correlation; that is, the observations fall exactly along a straight line and the value of one variable increases



decreases) as the other decreases (increases). In the example to the left, the equation of the straight line is

$$y = 200 - 4x$$

$$\text{or } x = 50 - \frac{1y}{4}$$

**QUESTION: 100**

A company is formulating its plans for the coming year, including the preparation of its cash budget. Historically, 30% of the company's sales are cash sales. The remaining 70% are credit sales with the following collection pattern.

<u>Collections on Account</u>	<u>Percentage</u>
In the month of sale	40%
In the month following the sale	58%
Uncollectible	2%

Sales for the first five months of the coming year are forecast as follows.

January	US \$3,500,000
February	3,800,000
March	3,600,000
April	4,000,000
May	4,200,000

For the month of April, the total cash receipts from sales and collections on account would be

- A. US \$3,729,968
- B. US \$3,781,600
- C. US \$4,025,200
- D. US \$4,408,000

**Answer: B**

The cash receipts for April equal April's cash sales (US \$4,000,000 x 30% = US \$1,200,000), 40% of April's credit sales, and 58% of March's credit sales. Consequently, total cash receipts equal US \$3,781,600 [(US \$1,200,000 + US \$4,000,000 x 40% x 70%) + US \$8,600,000 x 58% x 70%]. A bank has two drive-in lanes to serve customers: one attached to the bank itself and one on an island. One teller serves both stations. The bank is interested in determining the average waiting times of customers and has developed a model based on random numbers. The two key factors are the time between successive car arrivals and the time customers wait in line. Assume that the analysis begins with cars just arriving at both service windows, both requiring 3 minutes of service time. Car 1 is the attached window attached to the bank unless that window has more cars waiting than the island window. The lone teller will always serve the car that arrived first. If two cars arrive simultaneously, the one at the attached window will be served before the one at the island.

**QUESTION: 101**

The problem just described is best approached by use of which quantitative method?

- A. Integrated autoregressive-moving average (ARIMA) modeling.
- B. Exponential smoothing, multiple parameters.
- C. Queuing theory.
- D. Linear programming.

**Answer: C**

Two basic costs are involved in queuing (waiting-line) models: 1) the cost of providing service (including facility costs and operating costs), and 2) the cost of idle resources waiting in line. The latter may be a direct cost if paid employees are waiting, or an opportunity cost in the case of waiting customers. The objective of the queuing theory is to minimize the total cost of the system, including both service and waiting costs, for a given rate of arrivals. This minimization occurs at the point where the cost of waiting is balanced by the cost of providing service. A bank has two drive-in lanes to serve customers: one attached to the bank itself and one on an island. One teller serves both stations. The bank is interested in determining the average waiting times of customers and has developed a model based on random numbers. The two key factors are the time between successive car arrivals and the time customers wait in line. Assume that the analysis begins with cars just arriving at both service windows, both requiring 3 minutes of service time. Car 1 is the attached window attached to the bank unless that window has more cars waiting than the island window. The lone teller will always serve the car that arrived first. If two cars arrive simultaneously, the one at the attached window will be served before the one at the island.

**QUESTION: 102**

The techniques used in analyzing the problem is best described as

- A. Simultaneously theory.
- B. Integrated autoregressive-moving average (ARIMA) modeling.
- C. Linear programming
- D. Differential calculus.

**Answer: A**

Simulation is a technique for experimenting with logical/mathematical models using a computer. Despite the power of mathematics, many problems cannot be solved by known analytical methods because of the behavior of the variables and the complexity of their interactions. However, the performance of a quantitative model under uncertainty may be investigated by randomly selecting values for each of the variables in the model (based on the probability distribution of each variable) and then calculating the value of the solution. If this process is performed a large number of times, the distribution of results from the model will be obtained. A bank has two drive-in lanes to serve customers: one attached to the bank itself and one on an island. One teller serves both stations. The bank is interested in determining

the average waiting times of customers and has developed a model based on random numbers. The two key factors are the time between successive car arrivals and the time customers wait in line. Assume that the analysis begins with cars just arriving at both service windows, both requiring 3 minutes of service time. Car 1 is the attached window attached to the bank unless that window has more cars waiting than the island window. The lone teller will always serve the car that arrived first. If two cars arrive simultaneously, the one at the attached window will be served before the one at the island.

**QUESTION: 103**

The process of making sure that the model measures what it is supposed to measure is called

- A. Statistical inference.
- B. Hypothesis testing.
- C. Confidence coefficient analysis.
- D. Validation.

**Answer: D**

Validation is a step in the simulation procedure. Some assurance is needed that the results of the experiment will be realistic. This assurance requires validation of the model -- often using historical data. If the model gives results equivalent to what actually happened, the model is historically valid. There is still some risk, however, that changes could make the model invalid for the future.

**QUESTION: 104**

The marketing department of a company is deciding on the price to charge for a key product. In setting this price, marketing needs to consider the price that a major competitor will charge for a similar product because the competitor's price will affect the demand for the company's product. Similarly, in setting its price, the competitor will consider what the company will charge. What is an appropriate mathematical technique for analyzing such a decision?

- A. Game theory.
- B. Probability theory.
- C. Linear programming.
- D. Sensitivity analysis.

**Answer: A**

Game (or decision) theory is a mathematical approach to decision making when confronted with an enemy or competitor. Games are classified according to the number of players and the algebraic sum of the payoffs. In a two-person game, if the payoff is given by the loser to the winner, the algebraic sum is zero and the game is called a zero-sum game. If it is possible

for both players to profit, however, the game is a positive-sum game. Mathematical models have been developed to select optimal strategies for certain simple games.

**QUESTION: 105**

Because of the large number of factors that could affect the demand for its new product, interactions among these factors, and the probabilities associated with different values of these factors, the marketing department would like to develop a computerized model for projecting demand for this product. By using a random-number procedure to generate values for the different factors, it will be able to estimate the distribution of demand for this new product. This method of estimating the distribution of demand for the new product is called

- A. Monte Carlo simulation.
- B. Linear programming.
- C. Correlation analysis.
- D. Differential analysis.

**Answer: A**

Simulation is a technique in which a probabilistic process is first modeled. The inputs to the model are then varied a large number of times to estimate the distribution of possible outcomes from the model of the variable of interest. Simulations that use a random-number procedure to generate values for the inputs are referred to as Monte Carlo simulations.

**QUESTION: 106**

An account executive has just designed a Monte Carlo model to estimate the costs of a particular type of project. Validating the model could include all except

- A. Checking for errors in the computer programming.
- B. Checking that assumed probability distributions are reasonable.
- C. Comparing test results with previously validated models.
- D. Applying the model.

**Answer: D**

The Monte Carlo technique is used in a simulation to generate the individual values for a random value. An essential step in the simulation procedure is to validate the mathematical model used. This process involves not only searching for errors but also verifying the assumptions. It also should provide some assurance that the results of the experiment will be realistic. This assurance is often obtained using historical data. If the model gives results equivalent to what actually happened, the model is historically valid. There is still some risk, however, that changes could make the model invalid for the future. The model should not be implemented until this validation process is complete.

**QUESTION: 107**

A large fishing operation has information on the interval, time, and probabilities of shrimp schools staying beneath their fishing boats. In order to use this information to predict when and where to send their boats, which of the following techniques should be used?

- A. Simulation.
- B. Least squares.
- C. Queuing theory.
- D. Exponential smoothing.

**Answer: A**

Simulation (Monte Carlo simulation) is a technique for experimenting with logical/mathematical models using a computer. Despite the power of mathematics, many problems cannot be solved by known analytical methods because of the behavior of the variables and the complexity of their interactions. However, the performance of a quantitative model under uncertainty may be investigated by randomly selecting values for each variable in the model (based on its probability distribution) and then calculating the value of the solution. If this process is performed many times, the distribution of results from the model will be obtained.

**QUESTION: 108**

Which of the following is not true about simulation models?

- A. They are deterministic in nature.
- B. They may involve sampling.
- C. They mathematically estimate what actual performance would be.
- D. They emulate stochastic systems.

**Answer: A**

Simulation is a technique for experimenting with logical/mathematical models using a computer. The simulation procedure has five steps: define the objectives, formulate the model, validate the model, design the experiment, and conduct the simulation and evaluate the results. A simulation uses the laws of probability to generate values for random variables. Thus, simulation models are probabilistic, not deterministic.

**QUESTION: 109**

A cost-volume-profit model developed in a dynamic environment determined that the estimated parameters used may vary between limits. Subsequent testing of the model with respect to all possible values of the estimated parameters is termed

- A. A sensitivity analysis.
- B. Statistical estimation.
- C. Statistical hypothesis testing.
- D. A time-series study.

**Answer:** A

After a problem has been formulated into any mathematical model, it may be subjected to sensitivity analysis. Sensitivity analysis is a method for studying the effects of changes in one or more variables on the results of a decision model.

**QUESTION:** 110

An investment company is attempting to allocate its available funds between two investment alternatives, stocks and bonds, which differ in terms of expected return and risk. The company would like to minimize its risk while earning an expected return of at least 10% and investing no more than 70% in either of the investment alternatives. An appropriate technique for allocating its funds between stocks and bonds is

- A. Linear programming.
- B. Capital budgeting.
- C. Differential analysis.
- D. Queuing theory.

**Answer:** A

Linear programming is a mathematical technique for planning resource allocation that optimizes a given objective function that is subject to certain constraints. In this case, the maximum investment is constrained by a 70% limit on either investment choice.

**QUESTION:** 111

A company is deciding whether to purchase an automated machine to manufacture one of its products. Expected net cash flows from this decision depend on several factors, interactions among those factors, and the probabilities associated with different levels of those factors. The method that the company should use to evaluate the distribution of net cash flows from this decision and changes in net cash flows resulting from changes in levels of various factors is

- A. Simulation and sensitivity analysis.
- B. Linear programming.
- C. Correlation analysis.
- D. Differential analysis.

**Answer: A**

Simulation is a technique used to describe the behavior of a real-world system over time. This technique usually employs a computer program to perform the simulation computations. Sensitivity analysis examines how outcomes change as the model parameters change.

**QUESTION: 112**

In forecasting purchases of inventory for a firm, all of the following are useful except

- A. Knowledge of the behavior of business cycles.
- B. Internal allocations of costs to different segments of the firm.
- C. Information on the seasonal variations in demand.
- D. Econometric modeling.

**Answer: B**

Internal allocations of costs relate to costs already incurred, that is, to sunk costs. Sunk costs are not relevant to decision making, for example, to forecasting future purchases.

**QUESTION: 113**

A regression equation

- A. Estimates the dependent variables.
- B. Encompasses factors outside the relevant range.
- C. Is based on objective and constraint functions.
- D. Estimates the independent variable.

**Answer: A**

Regression analysis is used to find an equation for the linear relationship among variables. The behavior of the dependent variable is explained in terms of one or more independent variables. Regression analysis is often used to estimate a dependent variable such as cost given a known independent variable such as production).

**QUESTION: 114**

The correlation coefficient that indicates the weakest linear association between two variables is

- A. -0.73
- B. -0.11
- C. 0.12
- D. 0.35

**Answer: B**

The correlation coefficient can vary from -1 to +1. A -1 relationship indicates a perfect negative correlation, and a +1 relationship indicates a perfect positive correlation. A zero correlation coefficient would indicate no association between the variables. Thus, the correlation coefficient that is nearest to zero would indicate the weakest linear association. Of the options given in the question, the correlation coefficient that is nearest to zero is -0.11.

**QUESTION: 115**

Correlation is a term frequently used in conjunction with regression analysis and is measured by the value of the coefficient of correlation,  $r$ . The best explanation of the value  $r$  is that it

- A. Is always positive.
- B. Interprets variances in terms of the independent variable.
- C. Ranges in size from negative infinity to positive infinity.
- D. Is a measure of the relative relationship between two variables.

**Answer: D**

The coefficient of correlation ( $r$ ) measures the strength of the linear relationship between the dependent and independent variables. The magnitude of  $r$  is independent of the scales of measurement of  $x$  and  $y$ . The coefficient lies between -1.0 and +1.0. A value of zero indicates no linear relationship between the  $x$  and  $y$  variables. A value of +1.0 indicates a perfectly direct relationship, and a value of -1.0 indicates a perfectly inverse relationship.

**QUESTION: 116**

The four components of time series data are secular trend, cyclical variation, seasonality, and random variation. The seasonality in the data can be removed by

- A. Multiplying the data by a seasonality factor.
- B. Ignoring it.
- C. Taking the weighted average over four time periods.
- D. Subtracting a seasonality factor from the data.



**Answer: C**

Time series analysis relies on past experience. Changes in the value of a variable may have several possible components including secular trends, cyclical variation, seasonality, and random variation. Seasonal variations are common in many businesses. A variety of methods exist for including seasonal variations in a forecasting model, but most methods use a seasonal index. Alternatively, seasonal variations can be removed from data by using a weighted average of several time periods instead of data from individual periods.

**QUESTION: 117**

A widely used approach that managers use to recognize uncertainty about individual items and to obtain an immediate financial estimate of the consequences of possible prediction errors is

- A. Expected value analysis.
- B. Learning curve analysis.
- C. Sensitivity analysis.
- D. Regression analysis.

**Answer: C**

Sensitivity analysis determines how a result varies with changes in a given variable or parameter in a mathematical decision model. For example, in a present value analysis, a manager might first calculate the net present value or internal rate of return assuming that a new asset has a 10-year life. The NPV or IRR can then be recalculated using a 5-year life to determine how sensitive the result is to the change in the assumption. An international not-for-profit organization finances medical research. The majority of its revenue and support comes from fund-raising activities, investments, and specific grants from an initial sponsoring corporation. The organization has been in operation over 15 years and has a small internal audit department. The organization has just finished a major fundraising drive that raised US \$500 million for the current fiscal period. The following are selected data from recent financial statements (US dollar figures in millions):

	Current Year	Past Year
Revenue	US \$500	US \$425
Investments (average balances)	210	185
Medical research grants made	418	325
Investment income	16	20
Administrative expense	10	8

**QUESTION: 118**

The auditor wishes to determine if the change in investment income during the current year was due to a) changes in investment strategy, b) changes in portfolio mix, or c) other factors. Which of the following analytical review procedures should the auditor use?

- A. Simple linear regression that compares investment income changes over the past 5 years to determine the nature of the changes.
- B. Ratio analysis that compares changes in the investment portfolio on a monthly basis.
- C. Trend analysis that compares the changes in investment income as a percentage of total assets and of investment assets over the past 5 years.
- D. Multiple regression analysis that includes independent variables related to the nature of the investment portfolio and market conditions.

**Answer: D**

Regression analysis develops an equation to explain the behavior of a dependent variable (for example, investment income) in terms of one or more independent variables (for example, market risk and the risks of particular investments). Multiple regression analysis is the best approach because it allows the auditor to regress the change in investment income on more than one independent variable.

**QUESTION: 119**

Which of the following will allow a manufacturer with limited resources to maximize profits?

- A. The Delphi technique.
- B. Exponential smoothing.
- C. Regression analysis.
- D. Linear programming.

**Answer: D**

Linear programming is a technique used to optimize an objective function, that is, to maximize a revenue or profit function or to minimize a cost function, subject to constraints, e.g., limited (scarce) resources or minimum/maximum levels of production, performance, etc. In business, linear programming is used for planning resource allocations. Managers are often faced with problems of selecting the most profitable or least costly way to use available resources.

**QUESTION: 120**

Which of the following is not an appropriate time series forecasting technique?

- A. Least squares.
- B. Exponential smoothing.
- C. The Delphi technique.
- D. Moving averages.

**Answer: C**

The Delphi technique is an approach in which the manager solicits opinions on a problem from experts, summarizes the opinions, and feeds the summaries back to the experts without revealing any of the participants to each other). The process is reiterated until the opinions converge on an optimal solution. Thus, the Delphi technique is a qualitative, not a quantitative, method.

**QUESTION: 121**

The sales manager for a builder of custom yachts developed the following conditional table for annual production and sales

Demand Probability	10 0.1	20 0.2	30 0.5	50 0.2
Yachts Built	Expected Profit			
10	US \$10	US \$10	US \$10	US \$10
20	0	20	20	20
30	-10	10	30	30
50	-30	-10	10	50

According to the table, how many yachts should be built?

- A. 10
- B. 20
- C. 30
- D. 50

**Answer: C**

To achieve the maximum expected profit, 30 yachts should be built. For each level of production, multiply the probability of demand by the expected profit. The computation for the maximum is:

$$0.1 (-US \$10) + 0.2 (US \$10) + 0.5 (US \$30) + 0.2 (US \$10) = US \$22.$$

**QUESTION: 122**

All of the following are useful for forecasting the needed level of inventory except

- A. Knowledge of the behavior of business cycles.

- B. Internal accounting allocations of costs to different segments of the company.
- C. Information about seasonal variations in demand.
- D. Econometric modeling.

**Answer: B**

Forecasts are the basis for business plans. Models are used in the forecasting process to make decisions that optimize future results. Internal accounting allocations of costs to different segments of the company are arbitrary assignments of already incurred costs that do not have anything to do with forecasting demand. An organization has collected data on the complaints made by personal computer users and has categorized the complaints.

**QUESTION: 123**

Using the information collected, the organization should focus on

- A. The total number of personal computer complaints that occurred.
- B. The number of computer complaints associated with CD-ROM problems and new software usage.
- C. The number of computer complaints associated with the lack of user knowledge and hardware problems.
- D. The cost to alleviate all computer complaints.

**Answer: C**

Complaints based on lack of user knowledge and hardware problems are by far the most frequent according to this chart. Consequently, the company should devote its resources primarily to these issues. An organization has collected data on the complaints made by personal computer users and has categorized the complaints. An organization has collected data on the complaints made by personal computer users and has categorized the complaints.

**QUESTION: 124**

The chart displays the

- A. Arithmetic mean of each computer complaint.
- B. Relative frequency of each computer complaint.
- C. Median of each computer complaint.
- D. Absolute frequency of each computer complaint.

**Answer: D**

This Pareto diagram depicts the frequencies of complaints in absolute terms. It displays the actual number of each type of complaint. The chart does not display arithmetic means, relative frequencies, or medians of each type of complaint.

**QUESTION: 125**

A Gantt chart

- A. Shows the critical path for a project.
- B. Is used for determining an optimal product mix.
- C. Shows only the activities along the critical path of a network.
- D. Does not necessarily show the critical path through a network.

**Answer: D**

A Gantt or bar chart is sometimes used in conjunction with PERT or CPM to show the progress of a special project. Time is shown on the horizontal axis, the length of a bar equals the length of an activity, and shading indicates the degree of completion. However, the Gantt chart is not as sophisticated as PERT or CPM in that it does not reflect the relationships among the activities or define a critical path.

**QUESTION: 126**

As of week 8, the Gantt chart shows that the project is

- A. Complete.
- B. Ahead of schedule.
- C. On schedule.
- D. Behind schedule.

**Answer: B**

Assuming that 1) each of the bars represents the expected time necessary to complete an activity and 2) the shaded regions represent the portions completed, activity A has been completed as scheduled and activities B and C are ahead of schedule. Consequently, the project is ahead of schedule.

**QUESTION: 127**

When using PERT (Program Evaluation Review Technique), the expected time for an activity when given an optimistic time (A), a pessimistic time (B), and a most likely time (m) is calculated by which one of the following formulas?

- A.  $b - a) = 2$
- B.  $a + b) = 2$
- C.  $a + 4m + b) = 6$
- D.  $4 abm) = 6$

**Answer: C**

PERT was developed to aid managers in controlling large, complex projects. PERT analysis includes probabilistic estimates of activity completion times. Three time estimates are made: optimistic, most likely, and pessimistic. The time estimates for an activity are assumed to approximate a beta probability distribution. PERT approximates the mean of the beta distribution by dividing the sum of the optimistic time, the pessimistic time, and four times the most likely time by six.

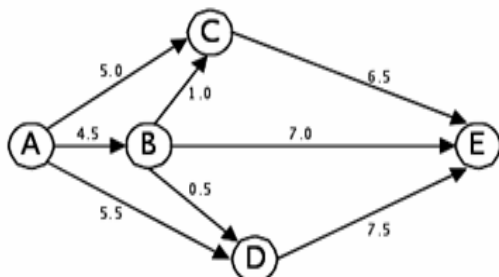
**QUESTION: 128**

The process of adding resources to shorten selected activity times on the critical path in project scheduling is called

- A. Crashing.
- B. The Delphi technique.
- C. ABC analysis.
- D. A branch-and-bound solution.

**Answer: A**

Activity times are estimated for normal effort and crash effort. Crashing is the process of adding resources to shorten activity times on the critical path in project scheduling. The network diagram and the corresponding activity cost chart for a manufacturing project at Networks, Inc. are presented below. The numbers in the diagram are the expected times (in days) to perform each activity in the project.



Activity	Normal Cost	Crash Time	Crash Cost
AB	US \$3,000	3.50 days	US \$4,000
AC	5,000	4.50	5,250
AD	4,000	4.00	4,750
BE	6,000	5.00	7,000
CE	8,000	5.00	9,200
DE	6,000	6.50	6,750
BC	2,500	.50	3,500
BD	2,000	.25	2,500

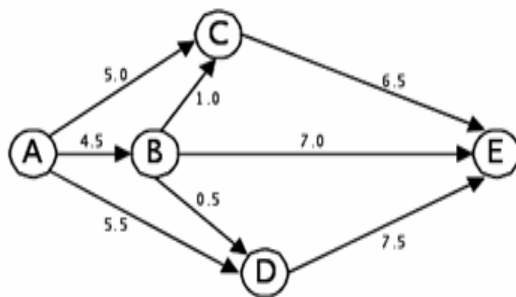
**QUESTION: 129**

The expected time of the critical path is

- A. 12.0 days.
- B. 13.0 days.
- C. 11.5 days.
- D. 11.0 days.

**Answer: B**

The critical path is the longest path. The longest path in the diagram is A-D-E, which requires 13 days ( $5.5 + 7.5$ ) based on expected times. The network diagram and the corresponding activity cost chart for a manufacturing project at Networks, Inc. are presented below. The numbers in the diagram are the expected times (in days) to perform each activity in the project.



Activity	Normal Cost	Crash Time	Crash Cost
AB	US \$3,000	3.50 days	US \$4,000
AC	5,000	4.50	5,250
AD	4,000	4.00	4,750
BE	6,000	5.00	7,000
CE	8,000	5.00	9,200
DE	6,000	6.50	6,750
BC	2,500	.50	3,500
BD	2,000	.25	2,500

**QUESTION: 130**

To keep costs at a minimum and decrease the completion time by 1-1/2 days, Networks, Inc. should crash activity (ies)

- A. AD and AB.
- B. DE.
- C. AD.
- D. AB and CE.

**Answer: A**

The critical (longest) path is A-D-E, which has an expected time of 13 days ( $5.5 + 7.5$ ). However, to decrease the project's completion time by 1.5 days, paths A-B-C-E ( $4.5 + 1.0 + 6.5 = 12$  days) and A-B-D-E ( $4.5 + .5 + 7.5 = 12.5$  days) as well as A-D-E must also be shortened. Hence, A-D-E must be reduced by 1.5 days, A-B-C-E by .5 day, and A-B-D-E by 1.0 day. The only way to decrease A-D-E by 1.5 days is to crash activity AD ( $5.5$  expected time -  $4.0$  crash time =  $1.5$  days). Crashing DE results in a 1.0-day saving ( $7.5 - 6.5$ ) only. Crashing AB is the efficient way to reduce both A-B-C-E and A-B-D-E by the desired amount of time because it is part of both paths. The incremental cost of crashing AB is US \$1,000 (US \$4,000 crash cost — US \$3,000 normal cost) to shorten the completion time by

1.0 day 4.5 — 3.5). The alternatives for decreasing both A-B-C-E and A-B-D-E are more costly.

**QUESTION: 131**

When making a cost-time trade-off in PERT analysis, the first activity that should be crashed is the activity

- A. With the largest amount of slack.
- B. With the lowest unit crash cost.
- C. On the critical path with the maximum possible time reduction
- D. On the critical path with the lowest unit crash cost

**Answer: D**

When making a cost-time trade-off, the first activity to be crashed (have its completion time accelerated) is one on the critical path. To select an activity on another path would not reduce the total time of completion. The initial activity chosen should be the one with the completion time that can be accelerated at the lowest possible cost per unit of time saved.

**QUESTION: 132**

In PERT, slack is the

- A. Uncertainty associated with time estimates.
- B. Difference between the latest starting time and earliest finishing time.
- C. Path that has the largest amount of time associated with it.
- D. Number of days an activity can be delayed without forcing a delay for the entire project.

**Answer: D**

PERT diagrams are free-form networks showing each activity in a large project as a line between events. The critical path is the longest path in time through the network. That path is critical in that, if any activity on the critical path takes longer than expected, the entire project will be delayed. Paths that are not critical have slack time. Slack is the number of days an activity can be delayed without forcing a delay for the entire project.

**QUESTION: 133**

The network below describes the interrelationships of several activities necessary to complete a project. The arrows represent the activities. The numbers between the arrows indicate the number of months to complete each activity. The shortest time to complete the project is



- A. 5 months.
- B. 6 months.
- C. 8 months.
- D. 14 months.

**Answer: C**

The longest, or critical, path in the network from node A) to node F) is path A- -D-F. All other paths are shorter than path A-C-D-F, so the activities along those paths can be completed before the activities along path A-C-D-F. Thus, the shortest time to complete the project is 8 months (3 + 3 + 2).

**QUESTION: 134**

A shortest-route algorithm is used in network models to

- A. Identify bottlenecks in a network and hence identify the longest path.
- B. Minimize total travel time from one site to each of the other sites in a transportation system.
- C. Maximize throughput in networks with distinct entry (source node) and exit (sink node) points.
- D. Identify the set of connecting branches having the shortest combined length.

**Answer: B**

Network models are used to solve managerial problems pertaining to project scheduling, information systems design, and transportation systems design. Networks consisting of nodes and arcs may be created to represent in graphic form problems related to transportation, assignment, and transshipment. The shortest-route, minimal spanning tree, and maximal flow problems are other applications of network models. A shortest-route algorithm minimizes total travel time from one site to each of the other sites in a transportation system.

**QUESTION: 135**

Which of the following project scheduling techniques is commonly used in total quality management for simplifying work processes?

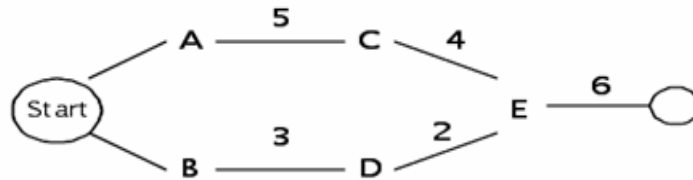
- A. Gantt charts.
- B. Flowcharting.
- C. Program evaluation and review technique.
- D. Critical path method.

**Answer: B**

Flowcharting is commonly used in computer programming for determining program logic and in total quality management for simplifying work processes. However, they are also used for establishing the desirable sequence of activities and decisions.

**QUESTION: 136**

The following information and diagram apply to a project:



Activity	Time (days)	Immediate Predecessor
A	5	None
B	3	None
C	4	A
D	2	B
E	6	C, D

The earliest completion time for the project is

- A. 11 days.
- B. 14 days.
- C. 15 days.
- D. 20 days.

**Answer: C**

The two paths through the network are A-C-E (5 + 4 + 6 = 15 days) and B-D-E (3 + 2 + 6 = 11 days). The critical or longest path is thus A-C-E. Hence, the earliest completion time is 15 days.

**QUESTION: 137**

Which of the following terms is not used in project management?

- A. Dummy activity.
- B. Latest finish.
- C. Optimistic time.
- D. Lumpy demand.

**Answer: D**

Project management concerns managing teams assigned to special projects. Lumpy demand refers to periodic demand for a product or service that increases in large, lumpy increments.

**QUESTION: 138**

Activity scheduling information for the installation of a new computer system is given below

<u>Activity</u>	<u>Immediate Predecessor</u>	<u>Duration (Days)</u>
A	-	4
B	-	3
C	A	9
D	A	6
E	B, D	5

The earliest completion time for the project is

- A. A-C.
- B. B-E.
- C. A-D-E.
- D. B-D-C.

**Answer: C**

The critical path is the longest path because it defines the minimum duration of the project. A-D-E  $4 + 6 + 5 = 15$ ) is the critical path.

**QUESTION: 139**

In a critical path analysis, if slack time in an activity exists, the activity

- A. Is not essential to the overall project.
- B. Is a backup activity to replace a main activity should it fail.
- C. Could be delayed without delaying the overall project.
- D. Involves essentially no time to complete.

**Answer: C**

Slack is the free time associated with each activity. In other words, paths that are not critical have slack time. Slack represents unused resources that can be diverted to the critical path.

**QUESTION: 140**

The primary difference between PERT and CPM is that

- A. CPM uses probabilities on the activity times and PERT does not.
- B. PERT considers activity costs and CPM does not.
- C. PERT can assign probabilities to activity times and CPM does not.
- D. CPM considers activity costs and PERT does not.

**Answer: D**

Both PERT and CPM are network analysis techniques. But CPM was developed independently of PERT and is widely used in the construction industry. CPM may be thought of as a subset of PERT. Like PERT, it is a network technique, but, unlike PERT, it uses deterministic time and cost estimates. Its advantages include cost estimates plus the concept of "crash" efforts and costs. Activity times are estimated for normal effort and crash effort. Crash time is the time to complete an activity assuming that all available resources were devoted to the task (overtime, extra crew, etc.). Activity costs are also estimated for normal and crash efforts. These estimates allow the project manager to estimate the costs of completing the project if some of the activities are completed on a crash basis. The network diagram is constructed in the same manner as PERT diagrams. Once the diagram is constructed, the critical paths are found for normal and crash times. More than one critical path may exist for each diagram.

**QUESTION: 141**

Is PERT analysis a control tool or a planning tool?

	<u>Planning</u>	<u>Control</u>
A.	Yes	No
B.	Yes	Yes
C.	No	Yes
D.	No	No

**Answer: B**

PERT (Program Evaluation and Review Technique) is applied in the management of complex projects. It analyzes the project in terms of its component activities and determines their sequencing and timing. Thus, it systematically combines planning with control.

**QUESTION: 142**

Various tools are employed to control large scale projects. They include all of the following except:

- A. PERT.
- B. GPM.
- C. Statistical process control
- D. Gantt charts.

**Answer: C**

Statistical process (quality) control is not used to control large scale projects. Statistical quality control is a method of determining whether the shipment or production run of units lies within acceptable limits. It is also used to determine whether production processes are out of control.

**QUESTION: 143**

Which of the following statements is false regarding the efficient and economical achievement of the organization's objectives?

- A. Economical performance accomplishes objectives with minimal use of resources with no regard to risk exposure.
- B. Efficient performance accomplishes objectives in a timely manner.
- C. Economical performance accomplishes objectives with minimal use of resources commensurate with the risk exposure.
- D. Efficient performance accomplishes objectives in an accurate and economical manner.

**Answer: A**

Efficient performance accomplishes objectives and goals in an accurate, timely, and economical fashion. Economical performance accomplishes objectives and goals with minimal use of resources (i.e., cost) commensurate with risk exposure. Thus, to achieve economical performance when accomplishing objectives, the minimal cost should correspond to the degree of risk exposure.

**QUESTION: 144**

Business process reengineering is most likely to

- A. Implement modern information systems technology to eliminate some controls.
- B. Be applied within individual departments.
- C. Improve existing procedures.
- D. Apply a continuous improvement model.

**Answer: A**

Reengineering and TQM techniques eliminate many traditional controls. They exploit modern technology to improve productivity and decrease the number of clerical workers. Thus, controls should be automated and self-correcting and require minimal human intervention. Moreover, auditors must be prepared to encounter and use) new technologies. The emphasis therefore shifts to monitoring so management can determine when an operation may be out of control and corrective action is needed.

**QUESTION: 145**

Monitoring is an important component of internal control. Which of the following is not an example of monitoring?

- A. Management regularly compares divisional performance with budgets for the division.
- B. Data processing management regularly generates exception reports for unusual transactions or volumes of transactions and follows up with investigation as to causes.
- C. Data processing management regularly reconciles batch control totals for items processed with batch controls for items submitted.
- D. Management has asked internal auditing to perform regular audits of the controls over cash processing.

**Answer: C**

Monitoring assesses the quality of internal control over time. Management considers whether internal control is properly designed and operating as intended and modifies it to reflect changing conditions. Monitoring may be in the form of separate, periodic evaluations or of ongoing monitoring. Ongoing monitoring occurs as part of routine operations. It includes management and supervisory review, comparisons, reconciliations, and other actions by personnel as part of their regular activities. However, reconciling batch control totals is a processing control. This information is relevant to a theory of constraints (TOC) analysis. A manufacturer that can sell all of its output produces its sole product using three operations. Each unit sells for US \$120, and direct materials costing US \$48 per unit are added at the start of the first operation. Other variable costs are immaterial. The following annual cost and capacity information is available concerning those operations:

	<u>Operation 1</u>	<u>Operation 2</u>	<u>Operation 3</u>
Total capacity per year	200,000 units	150,000 units	180,000 units
Total output per year	150,000 units	150,000 units	150,000 units
Fixed cost of operations (not including direct materials)	US \$1,200,000	US \$1,800,000	US \$2,250,000

**QUESTION: 146**

Assume that additional workers are hired for the bottleneck operation to expedite setups and materials handling. The cost of the additional workers is US \$50,000 per year. As a result, the annual output of the bottleneck operation will increase by 500 units. The change in operating income attributable to the increase in workers is

- A. US \$50,000
- B. US \$36,000
- C. US \$ 14,000)
- D. US \$ 20,000)

**Answer: C**

Operation 2 is the bottleneck because it is functioning at its capacity. The incremental annual throughput contribution revenues — direct materials costs) from adding workers to Operation 2 is US \$36,000 [500 units x \$120 unit price — \$48 DPI per unit)]. Because the cost of the additional workers is US \$50,000, the change in operating income is US \$ 14,000). This information is relevant to a theory of constraints (TOC) analysis. A manufacturer that can sell all of its output produces its sole product using three operations. Each unit sells for US \$120, and direct materials costing US \$48 per unit are added at the start of the first operation. Other variable costs are immaterial. The following annual cost and capacity information is available concerning those operations:

	Operation 1	Operation 2	Operation 3
Total capacity per year	200,000 units	150,000 units	180,000 units
Total output per year	150,000 units	150,000 units	150,000 units
Fixed cost of operations (not including direct materials)	US \$1,200,000	US \$1,800,000	US \$2,250,000

**QUESTION: 147**

Assume that C Company offers to perform the operation 2 function on 1,000 units at a unit price of US \$40, excluding direct materials cost. Also assume that Y Company offers to perform the Operation 1 function on 1,000 units at a unit price of US \$7, excluding direct materials cost. Which of these mutually exclusive offers is acceptable?

- A. C but not Y.
- B. Y but not C.
- C. X or Y.
- D. Neither offer should be accepted.

**Answer: A**

KG's offer should be accepted because its cost is US \$40,000 (1,000 units x \$40), but the increase in throughput contribution is US \$72,000 [1,000 units x \$120 unit price — \$48 E' 1 per unit)]. Hence, the relevant cost of QC's offer is less than the incremental throughput contribution. ms's offer effectively increases the capacity of the bottleneck operation. Y's offer should be rejected because, even though its US \$7 unit price is less than the US \$8 unit operating cost (excluding direct materials) for Operation 1, it will result in the incurrence of additional costs with no increase in throughput contribution, given that Operation 2 is already producing at its 150,000-unit capacity.

**QUESTION: 148**

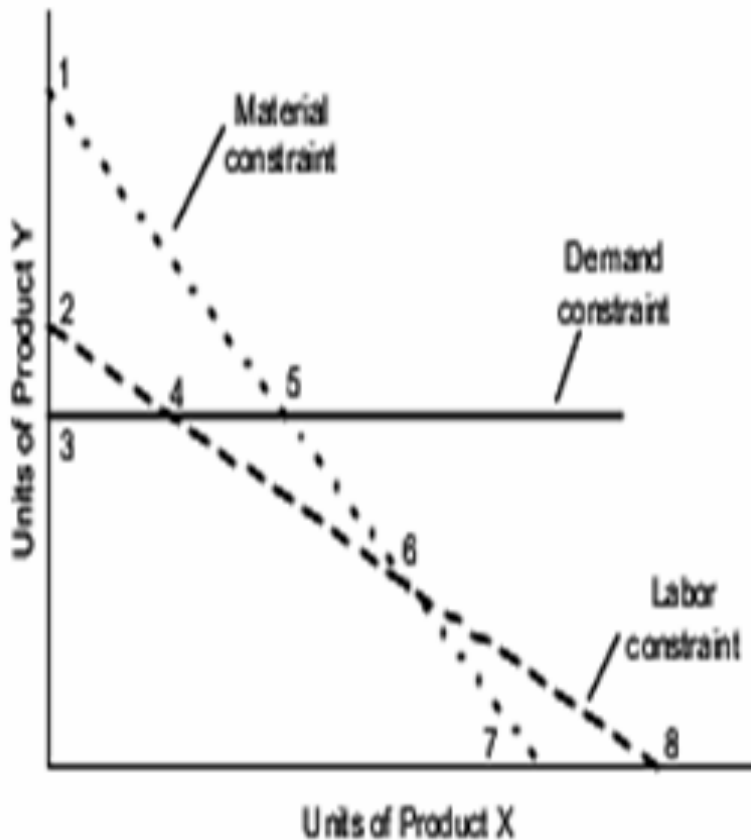
Company J produces two components: A-1 and A-2. The unit throughput contribution margins for A-1 and A-2 are US \$150 and US \$300, respectively. Each component must proceed through two processes: Operation 1 and Operation 2. The capacity of Operation 1 is 180 machine hours, with A-1 and A-2 requiring 1 hour and 3 hours, respectively. Furthermore, Company J can sell only 45 units of A-1 and 100 units of A-2. However, Company J is considering expanding Operation 1's capacity by 90 machine hours at a cost of US \$80 per hour. Assuming that Operation 2 has sufficient capacity to handle any additional output from Operation 1, how much should Company J produce?

	<u>Units of A-1</u>	<u>Units of A-2</u>
A.	180	0
B.	45	100
C.	45	75
D.	0	60

**Answer: C**

A-1's throughput contribution margin per unit of the scarce resource (the internal binding constraint) is US \$150 (\$150 UCM - 1 machining hour). A-2's throughput contribution margin per unit of the scarce resource is U \$100 (\$300 UCM - 3 machine hours). Consequently, Company J should produce as much A-1 as it can sell (45 units). If Company J adds 90 machine hours to increase the capacity of Operation -I to 270 hours (180 + 90), it cannot produce additional units of A-1 because the external binding constraint has not been relaxed. However, it can produce additional units of A-2. Given that the UCM per machine hour of A-2 is U \$100 and that the cost is US \$80 per hour, adding capacity to Operation 1 is profitable. Thus, Company J should use 45 machine hours to produce 45 units of A-1. The remaining 225 machine hours (270 - 45) should be used to produce 75 units (225 - 3 hours) of A-2. The latter amount is within the external binding constraint. A company produces two products, and Y, which use material and labor as inputs. Fixed amounts of labor and material are available for production each month. In addition, the demand for product Y each month is limited: product has no constraint on the number of units that can be sold. A graphical depiction of these production and demand constraints is presented in the opposite column.



**QUESTION:** 149

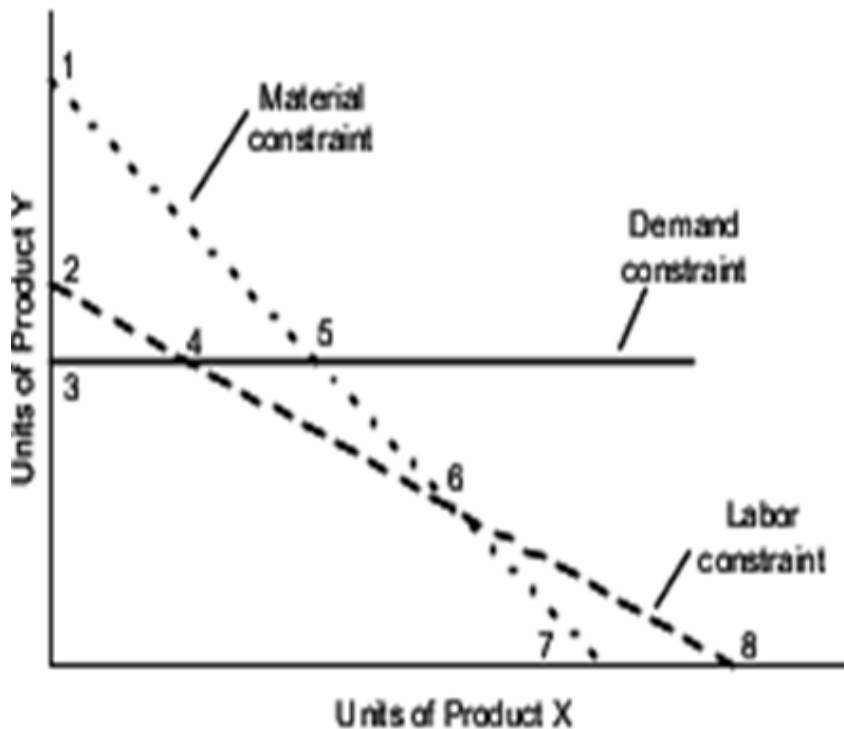
The feasible solution region is bounded by the lines connecting points

- A. 3, 4, 6, and 7.
- B. 1, 5, 6, and 8.
- C. 2, 4, 5, and 8.
- D. 3, 5, 6, and 7.

**Answer:** A

A model consisting of a system of functions may be used to optimize an objective function. If the functions in the model are all linear, the model is a linear programming model. Linear programming is a technique to determine optimal resource allocation. Several solution methods are available to solve linear programming problems. The graphical method, the easiest technique, is limited to simple problems. Here, the graph consists of three lines, each representing a production constraint. The lines connecting points 3, 4, 6, and 7 bound the feasible solution region. Product mixes of X and Y that lie outside this boundary cannot be produced and/or sold because the demand constraint (line 3,4), the labor constraint (line 4,6), and the material constraint (line 6,7) are binding. A company produces two products, X and Y, which use material and labor as inputs. Fixed amounts of labor and material are available for

production each month. In addition, the demand for product Y each month is limited: product Y has no constraint on the number of units that can be sold. A graphical depiction of these production and demand constraints is presented in the opposite column.



**QUESTION: 150**

If a series of profit lines for X and Y are drawn on the graph, the mix of X and Y that will result in the maximum profit can be determined from

- A. The last point in the feasible solution region touched by a profit line.
- B. Any point on the boundary of the feasible solution region touched by a profit line.
- C. The first point on the feasible solution region boundary that intersects a profit line.
- D. Any point on the demand constraint that intersects a profit line.

**Answer: A**

A. profit line has negative slope because the profit from sales of one product increases as the profit from sales of the other product declines. Moving the profit line rightward (while maintaining its slope) to the last point in the feasible region determines the solution.

**QUESTION: 151**

One drawback of business process reengineering (BPR), sometimes referred to as business process analysis, is

- A. Improved efficiency in the business processes analyzed.
- B. Excess of cost over the benefit.
- C. Reduction of operational efficiency.
- D. Employee resistance to change.

**Answer: D**

Business process reengineering (BPR), or business process analysis, involves process innovation and process redesign. Instead of improving existing procedures, it finds new ways of doing things. One major drawback of BPR is that employees may be resistant due to fear of layoffs, being replaced, or insecurity about new required skills or tasks that the employee now has to perform.

**QUESTION: 152**

Heniser Pet Foods manufactures two products, X. and Y. The unit contribution margins for Products X. and Y are US \$30 and US \$50, respectively. Each product uses Materials A and B. Product X uses 6 pounds of Material A and 12 pounds of Material B. Product Y uses 12 pounds of Material A and 8 pounds of Material B. The company can purchase only 1,200 pounds of Material A and 1,760 pounds of Material B. The optimal mix of products to manufacture is

- A. 146 units of X and 0 units of Y.
- B. 0 units of X and 100 units of Y.
- C. 120 units of X and 40 units of Y.
- D. 40 units of X. and 120 units of Y.

**Answer: C**

Linear programming is a technique used to maximize a contribution margin function or to minimize a cost function, subject to constraints such as scarce resources or minimum/maximum levels of production. Thus, linear programming is often used for planning resource allocations. In this problem, the equation to be maximized, called the objective function, is:  $U = \$30X + \$50Y$ . This equation is to be maximized subject to the constraints on materials. The two constraint functions are:

Material A:  $6X + 12Y < 1,200$

Material B:  $12X + 8Y < 1,760$

One way to solve this problem is to graph the constraint lines and determine the feasible area. The optimal production level is at an extreme point within the feasible area. The graph shows that a production level of 120 units of X and 40 units of Y is a feasible production level that maximizes the contribution margin.

**QUESTION: 153**

Dale has 20 days to complete production of an order for an important customer. The customer wants 96 units of product that may be painted either red or white. The red units can be produced at a rate of 4 per day. The white units, because of a different quality of paint, can be produced at a rate of 7 per day. The materials for the red units cost US \$80 each, while the white units cost US \$120 each. Dale wants to keep costs at a minimum. What is the constraint that expresses the number of units to be produced?

- A.  $4R + 7W = 20$
- B.  $(R - 4) + (W - 7) < 20$
- C.  $R + W = 20$
- D.  $4R + 7W = 96$

**Answer: B**

The constraint function that expresses the number of units to be produced is  $R + W = 96$ , but that is not one of the answer choices. Another constraint is that the total quantities of red (R) and white (W) units must be produced in 20 or fewer days at a rate of 4 red units per day and 7 white units per day. Thus, the time constraint is  $(R - 4) + (W - 7) \leq 20$ .

**QUESTION: 154**

The data below were gathered on two different machine centers and two products.

	Product Hours per Unit		Hours Available
	A	B	
Machine Center 1	2.5	4	60
Machine Center 2	6	3	70
Contribution per unit	US \$4	US \$5	

Which item below would be part of a linear programming formulation of this problem?

- A. Maximize: Contribution  $> 4A + 5B$ .
- B. Subject to:  $A < 0$ .
- C. Subject to:  $2.5A + 4B < 60$ .
- D. Subject to:  $4A + 5B < 130$ .

**Answer: C**

The linear programming solution is subject to constraints on the availability of machine hours in both centers. For example, products A and B require 2.5 and 4 hours per unit, respectively, in Machine Center 1, but only 60 hours are available. Hence, the optimal production of A and B to the following constraint:

$$2.5A + 4B < 60$$

**QUESTION: 155**

A firm must decide the mix of production of Product X and Product Y. There are only two resources used in the two products, resources A and B. Data related to the two products is given in the following table:

	Products	
	X	Y
Resource A	3	7
Resource B	2	1
Unit Profit	US \$8	US \$6

What is the appropriate objective function to maximize profit?

- A.  $3X + 7Y$
- B.  $2X + Y$
- C.  $8X + 6Y$
- D.  $5X + 8Y$

**Answer: C**

The objective function is the function to be optimized. This firm wishes to maximize profits on the sales of two products (X and Y). Based on profits per unit (US \$8 and US \$6, respectively), the objective function is  $8X + 6Y$ .

**QUESTION: 156**

To remove the effect of seasonal variation from a time series, original data should be

- A. Increased by the seasonal factor.
- B. Reduced by the seasonal factor.
- C. Multiplied by the seasonal factor.
- D. Divided by the seasonal factor.

**Answer: D**

Seasonal variations are common in many businesses. To remove the effect of seasonal variation from a time series, the original data (with the four trends) is divided by the seasonal norm.

**QUESTION: 157**

Sales representatives for a manufacturing company are reimbursed for 100 percent of their cellular telephone bills. Cellular telephone costs vary significantly from representative to representative and from month to month, complicating the budgeting and forecasting processes. Management has requested that the internal auditors develop a method for

controlling these costs. Which of the following would most appropriately be included in the scope of the consulting project?

- A. Control self-assessment involving sales representatives.
- B. Benchmarking with other cellular telephone users.
- C. Business process review of procurement and payables routines.
- D. Performance measurement and design of the budgeting and forecasting processes.

**Answer: C**

A business process review (BPR) assesses the performance of administrative, financial, and other processes, such as those within the procurement and payables functions. BPR considers process effectiveness and efficiency, including the presence of appropriate controls, to mitigate business risk. It seeks to achieve improvements in such critical measures of performance as cost, quality, service, speed, and customer satisfaction. Because the objective is to control cellular phone costs, BPR is the appropriate tool.

Section 2: Sec Two (158 to 276)

Details: Managing Resources and Pricing

**QUESTION: 158**

The order costs associated with inventory management include

- A. Insurance costs, purchasing costs, shipping costs, and obsolescence.
- B. Obsolescence, setup costs, quantity discounts lost, and storage costs.
- C. Quantity discounts lost, storage costs, handling costs, and interest on capital invested.
- D. Purchasing costs, shipping costs, setup costs, and quantity discounts lost.

**Answer: D**

Order costs include purchasing costs, shipping costs, setup costs for a production run, and quantity discounts lost.

**QUESTION: 159**

The carrying costs associated with inventory management include

- A. Insurance costs, shipping costs, storage costs, and obsolescence.
- B. Storage costs, handling costs, capital invested, and obsolescence.
- C. Purchasing costs, shipping costs, setup costs, and quantity discounts lost.
- D. Obsolescence, setup costs, capital invested, and purchasing costs.

**Answer: B**

Carrying costs include storage costs, handling costs, insurance costs, interest on capital invested, and obsolescence. Candman Company is a wholesale distributor of candy. The company leases space in a public warehouse and is charged according to the square feet occupied. Candman has decided to employ the economic order quantity (EOQ) method to determine the optimum number of cases of candy to order. The company placed 2,400 orders last year. Data for the high-activity month, the low-activity month, and the year for the purchasing and warehouse operations appear in the next column. The annual charges for the warehouse totaled US \$12,750 last year. In addition, the annual insurance and property taxes on the candy stored in the warehouse amounted to US \$1,500 and US \$2,250, respectively. The average monthly inventory last year was US \$75,000.

Long-term capital investments are expected to earn 12% after income taxes. Candman is subject to an effective income tax rate of 40%.

	High-Activity Month (160 Orders)	Low-Activity Month (100 Orders)	Annual Costs
Purchasing			
Dept.			
Manager	US \$ 1,600	US \$1,600	US \$ 23,400
Clerks	1,750	1,250	18,000
Supplies	400	260	3,500
Warehouse			
Supervisor	1,550	1,550	18,600
Rcvg. clerks	2,200	1,700	20,500
Ship. clerks	2,800	2,500	31,200
Totals	<u>US \$10,300</u>	<u>US \$8,860</u>	<u>US \$115,200</u>

**QUESTION: 160**

What is the incremental cost of placing an order that would be used in the EOO model?

- A. US \$48
- B. US \$35
- C. US \$24
- D. US \$19

**Answer: D**

The incremental cost of additional orders equals the variable costs incurred in purchasing and receiving inventory but not costs associated with shipping). Using the high-low method of analysis, these variable costs can be computed by determining the apparent variable costs for the two given levels of activity. For 160 orders, the relevant costs with a variable element include purchasing clerks, US \$1,750; supplies, US \$400, and receiving clerks, US \$2,200. The total is US \$4,350. For 100 orders, these costs are US \$1,250, US \$260, and US \$1,700, respectively, for a total of US \$3,210. As the number of orders increased by 60, the costs increased by US \$1,140. Consequently, the variable or incremental costs per order must have been US \$19 (\$1,140 ÷ 60 orders). Candman Company is a wholesale distributor of

candy. The company leases space in a public warehouse and is charged according to the square feet occupied. Candman has decided to employ the economic order quantity (EOQ) method to determine the optimum number of cases of candy to order. The company placed 2,400 orders last year. Data for the high-activity month, the low-activity month, and the year for the purchasing and warehouse operations appear in the next column. The annual charges for the warehouse totaled US \$12,750 last year. In addition, the annual insurance and property taxes on the candy stored in the warehouse amounted to US \$1,500 and US \$2,250, respectively. The average monthly inventory last year was US \$75,000.

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Supervisor	1,550	1,550	18,600
Rcvg. clerks	2,200	1,700	20,500
Ship. clerks	2,800	2,500	31,200
Totals	<u>US \$10,300</u>	<u>US \$8,860</u>	<u>US \$115,200</u>

**QUESTION: 161**

What is the annual carrying cost, stated as a percentage of investment in inventory, that would be used in model?

- A. 42%
- B. 37%
- C. 34%
- D. 22%

**Answer: A**

The annual carrying costs are US \$12,750 for the warehouse, US \$1,500 for insurance, and US \$2,250 for property taxes. These costs total US \$16,500. In addition, the company desires a 12% after-tax return on investments. Because the tax rate is 40%, the 12% after-tax return equals a 20% before-tax return (12% ÷ 60%). A 20% return on the US \$75,000 average investment in inventory is US \$15,000. Hence, the total carrying cost is US \$31,500 (\$16,500 + \$15,000). This amount is 42% of the US \$75,000 investment in inventory.

**QUESTION: 162**

When the economic order quantity (EOQ) decision model is employed, the List A are being offset or balanced



	List A	List B
A.	Ordering costs	Carrying costs
B.	Purchase costs	Carrying costs
C.	Purchase costs	Quality costs
D.	Ordering costs	Stockout costs

**Answer:** A

The objective of the EOQ model is to find an optimal order quantity that balances carrying and ordering costs. Only variable costs should be considered. The EOQ is the point where the ordering cost and carrying cost curves intersect. It corresponds to the minimum point on the total inventory cost curve.

**QUESTION:** 163

The calculation of an economic order quantity (EOQ) considers

- A. The purchasing manager's salary\_
- B. A corporate charge for advertising expenses.
- C. The shipping costs to deliver the product to the customer.
- D. Capital costs.

**Answer:** D

The determination of the economic order quantity balances the variable costs of ordering and carrying inventory. Factors in the equation include the cost of placing an order, unit carrying cost, and annual demand in units. Carrying costs include storage costs, handling costs, insurance, property taxes, obsolescence, and the opportunity cost of investing capital in inventory. Thus, the return on capital that is forgone when it is invested in inventory should be considered.

**QUESTION:** 164

A characteristic of the basic economic order quantity (EOQ) model is that it

- A. Is relatively insensitive to error.
- B. Should not be used when carrying costs are large in relation to procurement costs.
- C. Is used when product demand, lead-time, and ordering costs are uncertain.
- D. Should not be used in conjunction with computerized perpetual inventory systems.

**Answer:** A

The basic EOQ model equals the square root of the quotient of 1) the product of twice the demand times the cost per order, ) divided by the periodic carrying cost. Hence, the model is

relatively insensitive to error. A given percentage error in a value results in a lower percentage change in the EOQ.

**QUESTION: 165**

Companies that adapt just-in-time purchasing systems often experience

- A. An increase in carrying costs.
- B. A reduction in the number of suppliers.
- C. A greater need for inspection of goods as the goods arrive.
- D. Less need for linkage with a vendor's computerized order entry system.

**Answer: B**

The objective of JIT is to reduce carrying costs by eliminating inventories and increasing the deliveries made by suppliers. Ideally, shipments of raw materials are received just in time to be incorporated into the manufacturing process. The focus of quality control under JIT is the prevention of quality problems. Quality control is shifted to the supplier. JIT companies typically do not inspect incoming goods; the assumption is that receipts are of perfect quality. Suppliers are limited to those who guarantee perfect quality and prompt delivery.

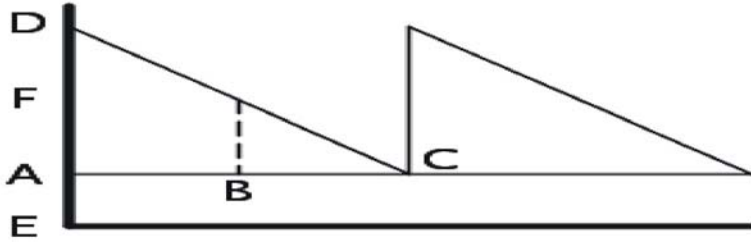
**QUESTION: 166**

A manufacturing company is attempting to implement a just-in-time (JIT) purchase policy system by negotiating with its primary suppliers to accept long-term purchase orders which result in more frequent deliveries of smaller quantities of raw materials. If the JIT purchase policy is successful in reducing the total inventory costs of the manufacturing company, which of the following combinations of cost changes would be most likely to occur?

	<u>Cost Category to Increase</u>	<u>Cost Category to Decrease</u>
A.	Purchasing costs	Stockout costs
B.	Purchasing costs	Quality costs
C.	Quality costs	Ordering costs
D.	Stockout costs	Carrying costs

**Answer: D**

The objective of a JIT system is to reduce carrying costs by eliminating inventories and increasing the deliveries made by suppliers. Ideally, shipments are received just in time to be incorporated into the manufacturing process. This system increases the risk of stockout costs because the inventory buffer is reduced or eliminated. The diagram presented represents the economic order quantity (EOQ) model.

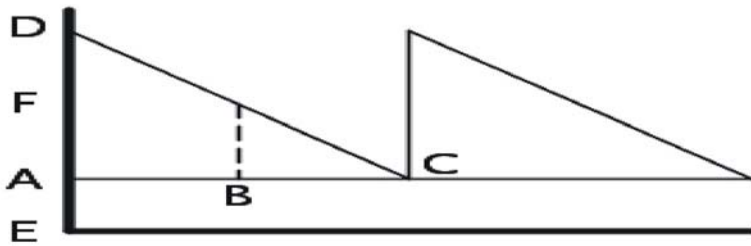
**QUESTION: 167**

Which line segment represents the reorder lead time?

- A. AB.
- B. AE.
- C. AF.
- D. BC.

**Answer: D**

The quantity of inventory on hand is represented by the y-axis and time by the x-axis. The reorder lead time is represented by the line segment BC. The diagram presented represents the economic order quantity (EOQ) model.

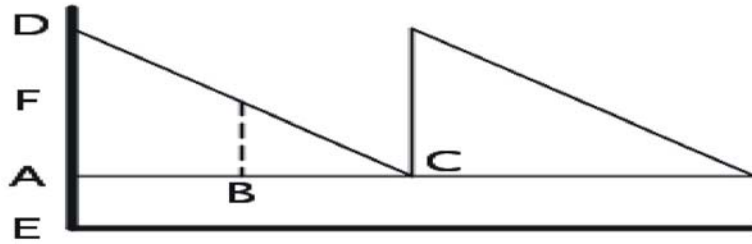
**QUESTION: 168**

Which line segment identifies the quantity of safety stock maintained?

- A. AB.
- B. AE.
- C. AC.
- D. BC.

**Answer: B**

Quantities of inventory are shown along the y-axis. Safety stock is represented by the line AE. The diagram presented represents the economic order quantity (EOQ) model.

**QUESTION: 169**

Which line segment represents the length of time to consume the total quantity of materials ordered?

- A. DE.
- B. BC.
- C. AC.
- D. AE.

**Answer: C**

Time is shown along the axis. The line segment AC depicts the time to consume an entire order to reduce the inventory to the safety stock).

**QUESTION: 170**

The Huron Corporation purchases 60,000 headbands per year. The average purchase lead time is 20 working days, and the maximum lead time is 27 working days. Safety stock equals 1,750 units. The corporation works 240 days per year. Huron should reorder headbands when the quantity in inventory reaches

- A. 5,000 units.
- B. 6,750 units.
- C. 1,750 units.
- D. 5,250 units.

**Answer: B**

The reorder point is the quantity on hand when an order is placed. If with a 20-day normal lead time, a safety stock of 1,750 units, and usage of 250 units per day, an order should be placed when 27 days of inventory are on hand, a total of 6,750 units (250 units 27 days). Jed Ryerson Computer Furniture, Inc. (RCF) manufactures a line of office computer chairs. The annual demand for the chairs is estimated to be 5,000 units. The annual cost to hold one unit in inventory is US \$10 per year, and the cost to initiate a production run is US \$1,000. There are no computer chairs on hand, and RCF has scheduled four equal production runs of computer chairs for the coming year, the first of which is to be run immediately. RCF has 250 business days per year, sales occur uniformly throughout the year, and production start-up is within

one day. RCF is considering using the following formula for determining the economic order quantity EOQ):

$$EOQ = \sqrt{\frac{2AD}{K}}$$

If: A = cost to initiate a production run per purchase order

D = annual unit demand

K = cost of carrying one unit per year

**QUESTION: 171**

What is the number of production runs per year of computer chairs that would minimize the sum of carrying and setup costs for the coming year?

- A. 1
- B. 2
- C. 4
- D. 5

**Answer: D**

The EOQ minimizes the sum of carrying and setup costs. The EOQ is the amount at which carrying costs are equal to setup costs. Thus, plugging the data into the EOQ formula results in the following:

$$EOQ = \sqrt{\frac{2 \text{ US } \$1000 \text{ 5000}}{\$10}} = 1,000 \text{ units}$$

Thus, if each lot consists of 1,000 units, five production runs per year are needed to meet the 5,000-unit demand. At this level, setup costs will total US \$5,000 (5 x \$1,000). Carrying costs will also equal US \$5,000 (10 per unit carrying cost average inventory of 500 units). Accordingly, total costs are minimized at US \$10,000. Jed Ryerson Computer Furniture, Inc. (RCF) manufactures a line of office computer chairs. The annual demand for the chairs is estimated to be 5,000 units. The annual cost to hold one unit in inventory is US \$10 per year, and the cost to initiate a production run is US \$1,000. There are no computer chairs on hand, and RCF has scheduled four equal production runs of computer chairs for the coming year, the first of which is to be run immediately. RCF has 250 business days per year, sales occur uniformly throughout the year, and production start-up is within one day. RCF is considering using the following formula for determining the economic order quantity EOQ):

$$EOQ = \sqrt{\frac{2AD}{K}}$$

If: A = cost to initiate a production run per purchase order

D = annual unit demand

$K$  = cost of carrying one unit per year

**QUESTION: 172**

If RCF does not maintain a safety stock, the estimated total carrying costs for the computer chairs for the coming year based on their current schedule is

- A. US \$4,000
- B. US \$5,000
- C. US \$6,250
- D. US \$12,500

**Answer: C**

Given four production runs and an annual demand of 5,000 units, each production run must generate 1,250 units. Inventory will total 1,250 units at the completion of each run but will decline to zero just prior to the next run. Thus, the average inventory is 625 units  $(1,250 - 2) / 2$ , and the total carrying cost is US \$6,250  $625 \text{ units} \times \$10$ ).

**QUESTION: 173**

Each stockout of a product sold by Company I-: costs US \$1,750 per occurrence. The carrying cost per unit of inventory is US \$5 per year, and the company orders 1,500 units of product 24 times a year at a cost of US \$100 per order. The probability of a stockout at various levels of safety stock is

<u>Units of Safety Stock</u>	<u>Probability of a Stockout</u>
0	.50
100	.30
200	.14
300	.05
400	.01

What is the optimal safety stock level for the company?

- A. 0 units.
- B. 100 units.
- C. 300 units.
- D. 400 units.

**Answer: D**

The total expected cost of safety stock equals the sum of the expected annual stockout cost and the expected annual carrying cost. Annual expected stockout cost equals the cost per occurrence US \$1,750), times the probability of a stockout per cycle, times the number of

cycles 24). Annual expected carrying cost of a safety stock equals the unit carrying cost US \$5) times the number of units. Hence, a safety stock of 400 units has the lowest total expected cost.

Units Held	Carrying Cost	Expected Stockout Cost Per Cycle	Expected Stockout Cost for 24 Cycles	Total Expected Cost
0	US \$ 0	US \$875.00	US \$21,000	US \$21,000
100	500	525.00	12,600	13,100
200	1,000	245.00	5,880	6,880
300	1,500	87.50	2,100	3,600
400	2,000	17.50	420	2,420

**QUESTION: 174**

A major justification for investments in computer-integrated manufacturing (CIM) projects is

- A. Reduction in the costs of spoilage, reworked units, and scrap.
- B. Lower Carr ring amount and depreciation expense for factory equipment.
- C. Increased working capital.
- D. Stabilization of market share.

**Answer: A**

Automating and computerizing production processes requires a substantial investment in fixed assets and an increase in risk because of greater fixed costs. CI also necessitates an increase in software costs and extensive worker retraining. However, the costs of spoilage, rework, and scrap are reduced along with labor costs. The qualitative advantages of I are increased flexibility, shorter manufacturing lead time, quicker development of new products, better product delivery and service, faster response to market changes, and improved competitiveness.

**QUESTION: 175**

A major benefit of computer integrated manufacturing (CIM) is

- A. Increased amount of scrap available for resale.
- B. Increased working capital.
- C. Delivery of customized products with long lead times.
- D. Increased flexibility.

**Answer: D**

CIM entails a holistic approach to manufacturing in which design is translated into product by centralized processing and robotics. CIM can help an organization reduce costs of spoilage, increase flexibility, and increase productivity. Flexibility is the key benefit. A traditional manufacturing system might become disrupted from an emergency change, but

CIII will reschedule everything in the plant when a priority requirement is inserted into the system.

**QUESTION: 176**

The effect of just-in-time production approaches

- A. Reduces the dependency on suppliers.
- B. Reduces the cost of implementing strategies.
- C. Decreases production facility flexibility.
- D. Increases the need for a dependable workforce.

**Answer: B**

Just-in-time (JIT) production approaches can reduce the cost of production. It lowers or eliminates inventory costs and requires production improvements to eliminate product defects.

**QUESTION: 177**

A manufacturer uses a materials requirements planning (MRP) system to track inventory, orders, and raw material requirements. A preliminary audit assessment indicates that the organization's inventory is understated. Using audit software, what conditions should the auditor search for in the MRP database to support this hypothesis?

- I. Item cost set at zero.
- II. Negative quantities on hand.
- III. Order quantity exceeding requirements.
- IV. Inventory lead times exceeding delivery schedule.

- A. I and II only.
- B. I and III only.
- C. II and III only.
- D. III and IV only.

**Answer: A**

If there is no monetary amount in the database for existing inventory, inventory will be understated. Moreover, inadequate edit checks or uncontrolled borrow/paybacks could cause negative quantities to be reported. This condition would cause inventory to be understated. If the amount ordered exceeds requirements, the result is an increase in inventory. However, by itself, this condition would not cause inventory to be understated or overstated. Also, if lead times are longer than delivery times, the effect is an increase in inventory but not necessarily a misstatement.



**QUESTION: 178**

The internal auditor found that the purchasing department has a policy of setting all purchasing lead times to the highest number of days experienced within each product subassembly}, even though some subassemblies required 3 or more months to complete. To address the objective of reducing inventory holding costs related to this policy, the internal auditor should focus on

- A. Reviewing production requirements for a sample of products to determine at which point in the production process materials and subassemblies are needed.
- B. Evaluating whether product-line assignments were rotated among the members of the purchasing department.
- C. Identifying signature approval authority} among members of the purchasing department in relation to any computer system controls.
- D. Testing those products having the highest sales to determine the average number of days that the completed products were held in inventory.

**Answer: A**

A The effect of this policy is to increase inventory holding carrying) costs. Using the longest lead time avoids stockout costs but ensures that many items will be delivered long before they are needed

**QUESTION: 179**

Just-in-time (JIT) inventory systems have been adopted by large manufacturers to minimize the carrying costs of inventories. Identify the primary vulnerability of JIT systems.

- A. Computer resources.
- B. Materials supply contracts.
- C. Work stoppages.
- D. Implementation time.

**Answer: C**

JIT minimizes inventory by relying on coordination with suppliers to provide deliveries when they are needed for production. Consequently, work stoppages are more likely due to stockouts, because the inventory buffer is reduced or eliminated.

**QUESTION: 180**

A company manufactures banana hooks for retail sale. The bill of materials for this item and the parts inventory for each material required are as follows:

Bill of Materials		
Raw Material	Quantity Required	On Hand
Wooden neck	1	0
Wooden base	1	0
Swag hook	1	300
Wood screws	2	400
Foot pads	4	1,000

An incoming order calls for deliver," of 2,000 banana hooks in 2 weeks. The company has 200 finished banana hooks in current inventory. If no safety stocks are required for inventory, what are the company's net requirements for swag hooks and screws needed to fill this order?

	Swag Hooks	Wood Screws
A.	1,500	1,400
B.	1,500	3,200
C.	1,700	3,600
D.	1,800	3,600

**Answer: B**

The company needs 1,800 banana hooks  $2,000 - 200$ ) and therefore 1,800 swag hooks  $1,800$ ) and 3,600 wood screws  $2 \times 1,800$ ). Given that 300 swag hooks and 400 wood screws are on hand, the company must obtain 1,500 swag hooks  $1,800 - 300$ ) and 3,200 wood screws  $3,600 - 400$ ).

**QUESTION: 181**

The purpose of the economic order quantity model is to:

- A. Minimize the safety stock.
- B. Minimize the sum of the order costs and the holding costs.
- C. Minimize the inventory quantities.
- D. Minimize the sum of the demand costs and the backlog costs.

**Answer: B**

The purpose of the EOQ model is to minimize the sum of inventory order costs setup) and holding carrying) costs. The EOQ equals the square root of: twice the annual demand multiplied by the variable cost per order, divided by the unit periodic holding cost.

**QUESTION: 182**

Which of the following is used in determining the economic order quantity (EOQ)?

- A. Regression analysis.
- B. Calculus.

- C. Markov process.
- D. Queuing theory

**Answer: B**

The primary business application of differential calculus is to identify the maxima or minima of curvilinear functions. In business and economics, these are the points of revenue or profit maximization (maxima) or cost minimization (minima). The result results from differentiating the total cost with regard to order quantity.

**QUESTION: 183**

The EOQ (economic order quantity) model calculates the cost-minimizing quantity of a product to order, based on a constant annual demand, carrying costs per unit per annum, and cost per order. For example, the EOQ is approximately 447 units if the annual demand is 10,000 units, carrying costs are US \$1 per item per annum, and the cost of placing an order is US \$10. What will the EOQ be if the demand falls to 5,000 units per annum and the carrying and ordering costs remain at US \$1 and US \$10, respectively?

- A. 316
- B. 447
- C. 483
- D. 500

**Answer: A**

The EOQ formula is

$$X = \left( \frac{2AD}{K} \right)^{1/2}$$

Answer (A) is **correct**. The EOQ formula is

$$X = \left( \frac{2AD}{K} \right)^{1/2}$$

If: D is the demand, or number of units used per year.

A is the cost of placing one order.

K is the cost of carrying one item for 1 year.

$$\left( \frac{2 \times \text{US } \$10 \times 5,000}{\text{US } \$1} \right)^{1/2} = 316.23$$

**QUESTION: 184**

A company stocks, maintains, and distributes inventory. The company decides to add to the safety stock and expedite delivery for several product lines on a trial basis. For the selected product lines the company will experience

- A. An increase in some costs but no change in the service level.
- B. A change in the service level.
- C. An increase in ordering, carrying, and delivery costs.
- D. decrease in ordering, carrying, and delivery costs.

**Answer: B**

Safety stocks are amounts held in excess of forecasted demand to avoid the losses associated with stockouts. Holding safety stocks improves the level of service to customers at the expense of increased holding costs.

**QUESTION: 185**

Which of the following inventory items would be the most frequently reviewed in an ABC inventory control system?

- A. Expensive, frequently used, high stock-out cost items with short lead times.
- B. Expensive, frequently used, low stock-out cost items with long lead times.
- C. Inexpensive, frequently used, high stock-out cost items with long lead times.
- D. Expensive, frequently used, high stock-out cost items with long lead times.

**Answer: D**

The ABC system is a method for controlling inventories that divides inventory items into three groups:

Group A -- high-monetary value items, which account for a small portion perhaps 10%) of the total inventory usage

Group B -- medium-monetary value items, which may account for about 20% of the total inventory items

Group C -- low-monetary value items, which account for the remaining 70% of sales or usage The ABC system permits the proper degree of managerial control to be identified and exercised over each group. Group A items are reviewed on a regular basis. Group B items may not have to be reviewed as often as group A items, but more often than group C items. For group C, extensive use of models and records is not cost effective. It is cheaper to order large quantities infrequently. The ABC method therefore reduces the safety-stock investment because high-value items are frequently monitored and medium-value items are monitored more often than inexpensive items. Frequent review can prevent stockouts and decrease inventory levels, and the cost of such review is minimized if it is limited to high- or medium-value items.

**QUESTION: 186**

The company uses a planning system that focuses first on the amount and timing of finished goods demanded and then determines the derived demand for raw material, components, and subassemblies at each of the prior stages of production. This system is referred to as

- A. Economic order quantity.
- B. Material requirements planning.
- C. Linear programming.
- D. Just-in-time purchasing.

**Answer: B**

materials requirements planning (MRF) is usually a computer-based information system designed to plan and control raw materials used in a production setting. It assumes that estimated demand for materials is reasonably accurate and that suppliers can deliver based upon this accurate schedule. It is crucial that delivery delays be avoided because, under MRF, production delays are almost unavoidable if the materials are not on hand. An MRF system uses a parts list, often called a bill of materials, and lead times for each type of material to obtain materials just as they are needed for planned production.

**QUESTION: 187**

An inventory planning method that minimizes inventories by arranging to have raw materials and subcomponents arrive immediately preceding their use is called

- A. A safety stock planning system.
- B. An economic order quantity model.
- C. A just-in-time inventory system.
- D. A master budgeting system.

**Answer: C**

JIT is a manufacturing philosophy popularized by the Japanese that combines purchasing, production, and inventory control. As with MFP, minimization of inventory is a goal; however, JIT also encompasses changes in the production process itself. An emphasis on quality and a "pull" of materials related to demand are key differences between JIT and MFP. The factory is organized so as to bring materials and tools close to the point of use rather than keeping them in storage areas. A key element of the JIT system is reduction or elimination of waste of materials, labor, factory space, and machine usage. Minimizing inventory is the key to reducing waste. When a part is needed on the production line, it arrives just in time, not before. Daily deliveries from suppliers are the ultimate objective, and some Japanese users have been able to get twice-daily deliveries.

**QUESTION: 188**

One of the elements included in the economic order quantity (EOQ) formula is

- A. Safety stock.
- B. Yearly demand.
- C. Selling price of item.
- D. Lead time for delivery.

**Answer: B**

The basic EOQ formula is used to minimize the total of inventory carrying and ordering costs. The basic EOQ equals the square root of a fraction consisting of a numerator equal to the product of twice the unit periodic demand and the variable cost per order and a denominator equal to the unit periodic carrying cost. Using an EOQ analysis assuming a constant demand), it is determined that the optimal order quantity is 2,500. The company desires a safety stock of 500 units. A five-day lead time is needed for delivery. Annual inventory holding costs equal 25% of the average inventory level. It costs the company U \$4 per unit to buy the product, which it sells for U \$. It costs the company U \$150 to place a detailed order, and the monthly demand for the product is 4,000 units.

**QUESTION: 189**

Annual inventory holding costs equal

- A. US \$750
- B. US \$1,250
- C. US \$1,750
- D. US \$2,250

**Answer: C**

Given that demand is constant and the EOQ is 2,500 units, the average inventory level—1 without regard to safety stock is 1,250 units  $2,500 - 2$ ). Adding safety stock results in an average level of 1,750 units  $1,250 + 500$ ). Given also that annual holding costs are 25% of average inventory and that unit cost is U \$4, total annual holding cost is U \$1,750  $[(1,750 \text{ units} : \$4) 25\%]$ . Using an EOQ analysis assuming a constant demand), it is determined that the optimal order quantity is 2,500. The company desires a safety stock of 500 units. A five-day lead time is needed for delivery. Annual inventory holding costs equal 25% of the average inventory level. It costs the company US \$4 per unit to buy the product, which it sells for US \$8. It costs the company US \$150 to place a detailed order, and the monthly demand for the product is 4,000 units.

**QUESTION: 190**

Total inventory ordering costs per year equal

- A. US \$1,250

- B. US \$2,400
- C. US \$2,880
- D. US \$3,600

**Answer: C**

Total annual demand is 48,000 units (4,000 per month x 12). Hence, total annual ordering costs equal US \$2,880 [\$150 cost per order 48,000 units / 2,500 EOQ].

**QUESTION: 191**

An organization sells a product for which demand is uncertain. Management would like to ensure that there is sufficient inventory on hand during periods of high demand so that it does not lose sales and customers). To do so, the organization should

- A. Keep a safety stock.
- B. Use a just-in-time inventory system.
- C. Employ a materials requirements planning system.
- D. Keep a master production schedule.

**Answer: A**

Safety stock is inventory maintained to reduce the number of stockouts resulting from higher-than-expected demand during lead time. Maintaining a safety stock avoids the costs of stockouts, e.g., lost sales and customer dissatisfaction.

**QUESTION: 192**

The economic order quantity is the size of the order that minimizes total inventory costs which include ordering and holding (carrying) costs. It can be calculated using the formula

$$Q = \left( \frac{2DP}{s} \right)^{1/2}$$

If Q = order size in units, D = annual demand in units, p = cost per purchase order, s = carrying cost per year for one unit of inventory. If the annual demand decreases by 36% the optimal order size will

- A. Decrease by 20%.
- B. Increase by 20%.
- C. Increase by 6%.
- D. Decrease by 6%.

**Answer:** A

D decreases by 36%, that is, from 100% to 64%. Because .64 is the square of .8, the EOQ for .64D Q~) equals 80% of the EOQ for D(Q).

$$\left[ \sqrt{\frac{2 \times .64D \times P}{s}} = .8 \sqrt{\frac{2Dp}{s}} \right]$$

**QUESTION:** 193

The economic order quantity. Q. is the size of the order that minimizes total inventory costs. These costs, which are composed of ordering and holding costs, can be computed using the following expression:

$$TC = \frac{QS}{2} + \left(\frac{D}{Q}\right)P + F$$

If: TC = total inventory costs  
 Q = size of each order  
 D = annual demand in units  
 F = fixed costs of ordering  
 p = variable cost of placing one order  
 s = holding (carrying) cost per year for one unit of inventory

The following inventory{ information is available for an organization:

Annual demand (D)	20,000 units
Variable cost of placing one order (p)	US \$100
Holding cost per unit (s)	\$1
Economic order quantity (Q)	2,000 units
Fixed cost of ordering	\$0

If the organization decides to order 4,000 units at a time rather than 2,000 units. by how much will its total inventory costs change?

- A. US \$500 increase
- B. US \$1,000 increase.
- C. US \$1,000 decrease.
- D. US \$900 increase.

**Answer:** A

When the order size is 2,000 units, the variable inventory costs are US \$2,000 {[ (2,000 units \$1) - 2] -I- [(20,000 units - 2,000 units) \$100]}. When the order size is 4,000 units, the variable inventory costs are US \$2,500 [1[(4,000 units \$1) - 2] + [(20,000 units - 4,000 units) \$100]}. The increase in inventory costs is US \$500 [\$2,500 - \$2,000].

**QUESTION:** 194

A decrease in inventory order costs will



- A. Decrease the economic order quantity.
- B. Increase the reorder point.
- C. Increase the economic order quantity.
- D. Decrease the holding cost percentage.

**Answer: A**

A decrease in inventory ordering costs should decrease the economic order quantity. The effect is that more orders can be made of smaller quantities) without increasing costs. Accordingly, in the EOQ model, ordering cost is a numerator value.

**QUESTION: 195**

Which one of the following items is not directly reflected in the basic economic order quantity (EOQ) model?

- A. Interest on invested capital.
- B. Inventory obsolescence.
- C. Public warehouse rental charges.
- D. Quantity discounts lost on inventory purchases.

**Answer: D**

The basic EOQ model minimizes the sum of ordering or setup) and carrying costs. Included in the formula are annual demand, ordering or setup) costs, and carrying costs. Carrying costs include warehousing costs, insurance, spoilage, obsolescence, and interest on invested capital. The cost of the inventory itself and any quantity discounts lost on inventory purchases are not components of the EOQ model.

**QUESTION: 196**

In production management, product breakdown into component parts and lead times for procuring these parts is necessary for

- A. A critical path method (CPM) system.
- B. A materials requirements planning (MRP) system.
- C. An economic order quantity (EOQ) system.
- D. An ABC system.

**Answer: B**

Materials requirements planning (MRP) is usually considered a computer-based information system designed to plan and control raw materials used in a production setting. It assumes that estimated demand for materials is reasonably accurate and that suppliers can deliver

based upon this accurate schedule. It is crucial that delivery delays be avoided because, under MRP, production delays are almost unavoidable if the materials are not on hand. An MRP system uses a parts list, often called a bill of materials, and lead times for each type of material to obtain materials just as they are needed for planned production.

**QUESTION:** 197

The inventory model that follows the concept that 80% of the value of an inventory is in 20% of the inventory items is the

- A. ABC system.
- B. Economic order quantity (EOQ) model.
- C. Just-in-time inventory system.
- D. Materials requirements planning (MRP) system.

**Answer:** A

The ABC method of inventory control requires management to exert greatest control over the A classification items, which usually include a relatively small percentage of total items but a high percentage of the dollar volume. This method is analogous to the 80/20 rule, which says, for instance, that 20% of the customers account for 80% of the profit.

**QUESTION:** 198

When a specified level of safety stock is carried for an item in inventory, the average inventory level for that item

- A. Decreases by the amount of the safety stock.
- B. Is one-half the level of the safety stock.
- C. Increases by one-half the amount of the safety stock.
- D. Increases by the amount of the safety stock.

**Answer:** D

If there is no safety stock, the average level of inventory will be one-half of the economic order quantity. For example, if the EOQ is 500, the basic model predicts that the average inventory level will be 250. The company will have 500 units immediately after a purchase and zero immediately before the receipt of the next purchase replenishment is assumed to be instantaneous). However, safety stock increases the average inventory level by the amount of the safety stock. The modified EOQ model assumes that safety stock will never be used. Thus, if a safety stock of 100 is carried by the company in the example, the average inventory level will increase to 350. Inventory will be 600 units immediately upon receipt of a purchase and 100 units immediately before the receipt of the next purchase.

**QUESTION: 199**

An appropriate technique for planning and controlling manufacturing inventories, such as raw materials, components, and subassemblies whose demand depends on the level of production is

- A. Materials requirements planning.
- B. Regression analysis.
- C. Capital budgeting.
- D. Linear programming.

**Answer: A**

Materials requirements planning (MRP) is a system that translates a production schedule into requirements for each component needed to meet the schedule. It is usually implemented in the form of a computer-based information system designed to plan and control raw materials used in production. It assumes that forecasted demand is reasonably accurate and that suppliers can deliver based upon this accurate schedule. MRP is a centralized push-through system, output based on forecasted demand is pushed through to the next department or to inventory.

**QUESTION: 200**

An advantage of using bar codes rather than other means of identification of parts used by a manufacturer is that

- A. The movement of all parts is controlled.
- B. The movement of parts is easily and quickly recorded.
- C. Vendors can use the same part numbers.
- D. Vendors use the same identification methods.

**Answer: B**

A reason to use bar codes rather than other means of identification is to record the movement of parts with minimal labor costs.

**QUESTION: 201**

If a just-in-time purchasing policy is successful in reducing the total inventory costs of a manufacturing company, which of the following combinations of cost changes would be most likely to occur?

- A. An increase in purchasing costs and a decrease in stockout costs.

- B. An increase in purchasing costs and a decrease in quality costs.
- C. An increase in quality costs and a decrease in ordering costs.
- D. An increase in stockout costs and a decrease in carrying costs.

**Answer: D**

In this situation, the company will be receiving fewer materials at any point in time, increasing the likelihood of stockout and thereby resulting in an increase in a reduction in the carrying cost. At the same time, the average inventory will be less, resulting in a reduction in the carrying cost.

**QUESTION: 202**

In an economic order quantity (EOQ) model, both the costs per order and the holding costs are estimates. If those estimates are varied to determine how much the changes affect the optimal EOQ, such an analysis would be called a

- A. Forecasting model.
- B. Sensitivity analysis.
- C. Critical path method analysis.
- D. Decision analysis.

**Answer: B**

An economic order quantity (EOQ) sensitivity analysis involves varying the holding carrying) costs per unit and/or the order costs to determine how much the changes affect the optimal EOQ.

**QUESTION: 203**

With regard to inventory management, an increase in the frequency of ordering will normally

- A. Reduce the total ordering costs.
- B. Have no impact on total ordering costs.
- C. Reduce total carrying costs.
- D. Have no impact on total carrying costs.

**Answer: C**

Inventory carrying costs can sometimes be transferred to suppliers. If a seller has good enough control of demand schedules to know exactly when goods are needed, orders can be placed so that goods arrive no earlier than when actually needed. This practice relies on a supplier who is willing to take the responsibility for storing the needed inventory and

shipping it to arrive on time. Suppliers are more willing to provide this type of service when they have many competitors.

**QUESTION: 204**

An entity sells 1,500 units of a particular item each year and orders the items in equal quantities of 500 units at a price of US \$5 per unit. No safety stocks are held. If the entity has a cost of capital of 12%, its annual opportunity cost of carrying inventory is

- A. US \$150
- B. US \$180
- C. US \$300
- D. US \$900

**Answer: A**

The annual opportunity cost of carrying inventory equals the average inventory level times the cost per unit of inventory times the cost of capital. The average inventory level is the order quantity divided by 2. Thus, the annual opportunity cost of carrying inventory is US \$150  $[(500 \text{ units} / 2) \times \$5 \times .12]$ .

**QUESTION: 205**

Which must be part of any risk model involving inventory valuation?

- A. Product warranty policies.
- B. Vendor pricing policies.
- C. Inventory shrinkage expense.
- D. Annual sales forecasts.

**Answer: C**

The amount of inventory loss through shrinkage directly affects inventory valuation. Inventory shrinkage must be considered in risk models involving inventory valuation.

**QUESTION: 206**

A perpetual inventory system uses a minimum quantity on hand to initiate purchase ordering procedures for restocking. In reviewing the appropriateness of the minimum quantity level established by the stores department, the internal auditor is least likely to consider

- A. Stockout costs, including lost customers.
- B. Seasonal variations in forecasting inventory demand.

- C. Optimal order sizes determined by the economic order quantities model.
- D. Available storage space and potential obsolescence.

**Answer: C**

The basic economic order quantity (EOQ) model is based on the following variables: demand, variable cost per purchase order, and variable unit carrying cost. Thus, minimum stocking levels do not affect the EOQ.

**QUESTION: 207**

An organization must manage its flows of raw materials, components, finished goods, services, or information through intermediaries to ultimate consumers. These flows may occur across the functions in an organization's

- A. Supply chain.
- B. Value chain.
- C. Logistic chain.
- D. Integrated chain.

**Answer: B**

The supply chain consists of flows from sources of a) raw materials, b) components, c) finished goods, d) services, or e) information through intermediaries to ultimate consumers. These flows and the related activities may occur across the functions in an organization's value chain (R&D, design, production, marketing, distribution, and customer service). These flows and the related activities also may occur across separate organizations.

**QUESTION: 208**

The bullwhip, or whiplash, effect on inventories begins when retailers face uncertain demand from consumers caused by randomness in buying habits. It can be avoided by

- A. The need to purchase or manufacture goods in cost-efficient batches.
- B. Changes in price that may encourage purchases in anticipation of future increases.
- C. Shortages that may lead to rationing by suppliers or manufacturers and hoarding by manufacturers or retailers.
- D. Sharing of information and coordination among the organizations in the supply chain.

**Answer: D**

Sharing information about sales, inventory, pricing, advertising campaigns, and sales forecasts by all functions and organizations in the supply chain moderates demand uncertainty for all parties. The desired results are a) minimization of inventories held by

suppliers, manufacturers, and retailers; b) avoidance of stockouts; c) fewer rush orders; and d) production as needed by retailers.

**QUESTION: 209**

A desired result of the sharing of information by all functions and organizations in the supply chain is

- A. Fewer rush orders.
- B. Maximization of inventories held by suppliers, manufacturers, and retailers.
- C. Stockouts.
- D. Incompatibility of the information systems of the parties.

**Answer: A**

Sharing information about sales, inventory, pricing, advertising campaigns, and sales forecasts by all functions and organizations in the supply chain moderates demand uncertainty for all parties. The desired results are a) minimization of inventories held by suppliers, manufacturers, and retailers; b) avoidance of stockouts; c) fewer rush orders; and d) production as needed by retailers.

**QUESTION: 210**

Which of the following are intermediaries between sellers and buyers?

- I. Agent
- II. Broker
- III. Consignee I. Consumer

- A. I and II only.
- B. I and III only.
- C. I, II, and III only.
- D. I, II, III, and Isl.

**Answer: C**

A distribution channel is a series of interdependent marketing institutions that facilitate the transfer of a product from producer seller) to consumer buyer). Intermediaries include merchant middlemen, agents, brokers, consignees, and facilitating intermediaries.

**QUESTION: 211**

The channel structure in which producers, wholesalers, and retailers act as a unified system is a

- A. Horizontal distribution system.
- B. Vertical distribution system.
- C. Unilateral distribution system.
- D. Multichannel system.

**Answer: B**

In vertical distribution systems, producers, wholesalers, and retailers act as a unified system. Channel conflict is managed through common ownership, contractual relationships, or administration by one or a few dominant channel members. Horizontal distribution systems consist of two or more companies at one level of the channel working together to exploit new opportunities, such as the introduction of ATMs in supermarkets. The joint nature of horizontal distribution efforts is the tool for managing channel conflict. In a multichannel system, a single firm sets up two or more channels to reach one or more customer segments. Because such a system is managed by a single firm, channel conflicts can be evaluated and managed internally.

**QUESTION: 212**

Which of the following channel structures have the best means of managing channel conflict?

- I. Conventional
- II. Vertical
- III. Horizontal
- IV. Multichannel

- A. I and II.
- B. II, III, and IV.
- C. I, III, and IV.
- D. II and III.

**Answer: B**

In vertical distribution systems, channel conflict is managed through common ownership, contractual relationships, or administration by one or a few dominant channel members. The joint nature of horizontal distribution efforts is the tool for managing channel conflict. In a multichannel system, because such a system is managed by a single entity, channel conflicts can be evaluated and managed internally. Conventional distribution systems consist of one or more independent producers, wholesalers, and retailers, each of which is a separate profit-maximizing business. The profit objective of each independent channel member may result in actions that are not profit-maximizing for the system as a whole, and the conventional distribution system offers no means for controlling channel conflict.

**QUESTION: 213**



The airlines have been leaders in the use of technology. Customers can make reservations either with an airline or through a travel agency. In this situation, a travel agency is classified as which type of distribution channel?

- A. An intermediary.
- B. A jobber.
- C. A distributor.
- D. A facilitating agent.

**Answer: A**

Marketing intermediaries assist companies in promoting, selling, and distributing their goods and services to ultimate consumers. For example, travel agents access an airline's computerized reservation system and make reservations for their customers without ever taking title to the ticket.

**QUESTION: 214**

Physical distribution is the moving of finished products to

- A. Retail outlets.
- B. Shipping point.
- C. Consumers.
- D. Warehouses.

**Answer: C**

Physical distribution is the efficient management of supply chains. It controls value-added flows from suppliers to consumers.

**QUESTION: 215**

Intensive distribution is most likely to be used for

- A. Shopping goods.
- B. Specialty goods.
- C. Convenience goods.
- D. Unsought goods.

**Answer: C**

Convenience goods are consumer goods and services that are usually low-priced and widely available. Consumers buy them often and with a minimum of comparison and effort.

Examples are soap and newspapers. Producers of convenience goods ordinarily use intensive distribution to sell their products through a large number of retail or wholesale units.

**QUESTION: 216**

A distribution channel moves goods from producers to customers. Suppose a channel has four producers, each serving the same four customers, and no middlemen. If a distributor is introduced, the number of contacts among producers, customers, and the distributor) in the channel will

- A. Be unaffected.
- B. Decrease from 8 to 4.
- C. Increase from 8 to 16.
- D. Decrease from 16 to 8.

**Answer: D**

The number of contacts without a distributor is 16 (four producers four customers). The number with a distributor is 8 (four producers +four customers). Thus, the effort required of producers and consumers is reduced by the distributor, thereby increasing marketing efficiency.

**QUESTION: 217**

Which of the following is not a component of physical distribution?

- A. Transportation.
- B. Pricing.
- C. Location of retail outlets.
- D. Warehousing.

**Answer: B**

Physical distribution market logistics) involves planning, implementing, and controlling the movement of materials and final goods to meet customer needs while earning a profit. Physical distribution systems coordinate suppliers, purchasing agents, marketers, channels, and customers. They include warehousing, transportation, and retail outlets.

**QUESTION: 218**

Buyer-based pricing involves

- A. Adding a standard markup to the cost of the product.

- B. Determining the price at which the product will earn a target profit.
- C. Basing prices on the product's perceived value.
- D. Basing prices on competitors' prices.

**Answer: C**

Buyer-based pricing involves basing prices on the product's perceived value rather than on the seller's cost. Nonprice variables in the marketing mix augment the perceived value. For example, a cup of coffee may have a higher price at an expensive restaurant than at a fast-food outlet.

**QUESTION: 219**

Market-skimming pricing strategies could be appropriate when

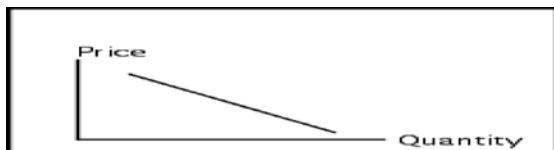
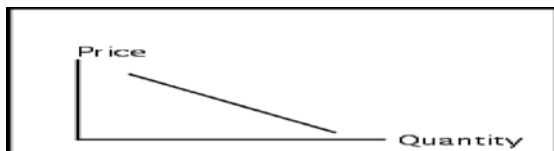
- A. No buyers want the product at a high price.
- B. The costs of producing a small volume are low.
- C. Competitors can easily enter the market.
- D. The product is of poor quality.

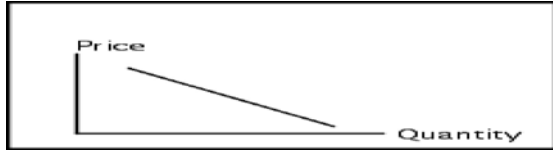
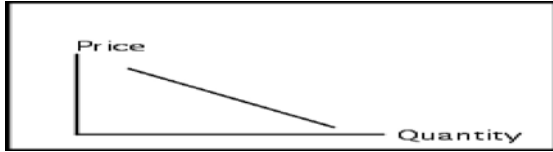
**Answer: B**

Market-skimming pricing is used when a new product is introduced at the highest price possible given the benefits of the product. For market skimming to work, the product must appear to be worth its price, the costs of producing a small volume cannot be so high that they eliminate the advantage of charging more, and competitors cannot enter the market and undercut the price.

**QUESTION: 220**

Which one of the graphs depicts the demand curve for prestige goods?



**Answer: C**

Over some intermediate range of prices, the reaction to a price increase for prestige goods is an increase, not a decrease, in the quantity demanded. Within this range, the demand curve is upward sloping. The reason is that consumers interpret the higher price to indicate a better or more desirable product. Above some price level, the relation between price and quantity demanded will again become negatively sloped.

**QUESTION: 221**

Which of the following pricing policies involves the selling company setting freight charges to customers at the actual average freight cost?

- A. Freight absorption pricing.
- B. Uniform delivered pricing.
- C. Zone pricing.
- D. FOB-origin pricing.

**Answer: B**

In uniform delivered pricing, the company charges the same price, inclusive of shipping costs, to all customers, regardless of their location. This price is the company's average actual freight cost. Thus, both nearby and distant customers are charged the same amount. This policy is easy to administer, permits the company to advertise one price nationwide, and facilitates marketing to faraway customers.

**QUESTION: 222**

A. seller's price is below an appropriate measure of costs. Moreover, the seller has a reasonable prospect of recovering the resulting loss in the future through higher prices or a greater market share. Accordingly, the seller has engaged in

- A. Collusive pricing.
- B. Dumping.

- C. Predatory pricing.
- D. Price discrimination.

**Answer: C**

Predatory pricing is intentionally pricing below cost to eliminate competition and reduce supply. Federal statutes and many state laws prohibit the practice. The U.S. Supreme Court has held that pricing is predatory when two conditions are met: 1) the seller's price is below an appropriate measure of its costs," and 2) it has a reasonable prospect of recovering the resulting loss through higher prices or greater market share.

**QUESTION: 223**

In which product-mix pricing strategy is it appropriate for the seller to accept any price that exceeds the storage and delivery costs for the product?

- A. By-product pricing.
- B. Optional-product pricing.
- C. Captive-product pricing.
- D. Product-bundle pricing.

**Answer: A**

A by-product is a product of relatively minor importance generated during the production of one or more other products. Its production entails no additional costs. Any amount received above the storage and delivery costs for a by-product allows the seller to reduce the main product's price to make it more competitive.

**QUESTION: 224**

Several surveys point out that most managers use full product costs, including unit fixed costs and unit variable costs, in developing cost-based pricing. Which one of the following is least associated with cost-based pricing?

- A. Price stability.
- B. Price justification.
- C. Target pricing.
- D. Fixed-cost recovery.

**Answer: C**

A target price is the expected market price of a product, given the company's knowledge of its customers and competitors. Hence, under target pricing, the sales price is known before the product is developed. Subtracting the unit target profit margin determines the long-term

unit target cost. If cost-cutting measures do not permit the product to be made at or below the target cost, it will be abandoned.

**QUESTION: 225**

Fulford Company applies the target pricing and costing approach. The following information about costs and revenues of Fulford's product are available for the year just ended:

Unit sales	60,000
Unit selling price	US \$400
Cost of goods sold	US \$13,200,000
Value-chain operating costs excluding production	US \$7,920,000

Fulford plans to increase unit sales to 80,000 by reducing the product's unit price to US \$320. If Fulford desires a unit target operating income of 12CYo, by what amount must it reduce the full cost per unit?

- A. US \$32.00
- B. US \$38.40
- C. US \$70.40
- D. US \$80.00

**Answer: C**

Unit target operating income is US \$38.40 (\$320 unit target price  $12\% \times$  US \$320). Hence, the unit target full cost is US \$281.60 (\$320 - \$38.40). The current full cost per unit is US \$352.00 [(\$13,200,000 CGS + \$7,920,000 other value chain operating costs) - 60,000 units sold], so the necessary reduction in the full cost per unit is US \$70.40 (\$352.00 - \$281.60).

**QUESTION: 226**

A company's product has an expected 4-year life cycle from research, development, and design through its withdrawal from the market. Budgeted costs are

Upstream costs (R&D, design)	US \$2,000,000
Manufacturing costs	3,000,000
Downstream costs (marketing, distribution, customer service)	1,200,000
After-purchase costs	1,000,000

The company plans to produce 200,000 units and price the product at 125% of the whole-life unit cost. Thus, the budgeted unit selling price is

- A. US \$15
- B. US \$31
- C. US \$36
- D. US \$45

**Answer: D**

Whole-life costs include after-purchase costs (operating, support, repair, and disposal) incurred by customers as well as life-cycle costs (R&D, design, manufacturing, marketing, distribution, and research). Hence, the budgeted unit whole-life cost is US \$36  $[(\$2,000,000 + \$3,000,000 + \$1,200,000 + \$1,000,000) \div 200,000 \text{ units}]$ , and the budgeted unit selling price is US \$45  $[\$36 + 12\% \text{ CYo}]$ .

**QUESTION: 227**

A manufacturing company produces plastic utensils for a particular segment at the lowest possible cost. The company is pursuing a cost

- A. Leadership strategy.
- B. Focus strategy.
- C. Differentiation strategy.
- D. Containment strategy.

**Answer: B**

A cost focus strategy aims at cost leadership in a particular segment, such as a regional market or a specialty product line. The rationale for a focus strategy is that the narrower market can be better served.

**QUESTION: 228**

The dominant firm in a market pursues a market-leader strategy. This strategy may involve

- A. Holding the market stable to avoid attracting new competitors.
- B. A flank defense to strengthen the firm's brand.
- C. Sending market signals as a mobile defense.
- D. Innovations as an offensive strategy.

**Answer: D**

Constant innovation to improve products and services, control costs, and increase distribution effectiveness is the basis for a good offensive strategy. The leader must continuously improve the value offered to customers.

**QUESTION: 229**

During the growth stage of a product's life cycle,

- A. The quality of products is poor.
- B. New product models and features are introduced.
- C. There is little difference between competing products.
- D. The quality of the products becomes more variable and products are less differentiated.

**Answer: B**

In the growth stage, sales and profits increase rapidly, cost per customer decreases, customers are early adopters, new competitors enter an expanding market, new product models and features are introduced, and promotion spending declines or remains stable. The firm enters new market segments and distribution channels and attempts to build brand loyalty and achieve the maximum share of the market. Thus, prices are set to penetrate the market, distribution channels are extended, and the mass market is targeted through advertising. The strategy is to advance by these means and by achieving economies of productive scale.

**QUESTION: 230**

In a product's life cycle, the first symptom of the decline stage is a decline in the

- A. Firm's inventory levels.
- B. Product's sales.
- C. Product's production cost.
- D. Product's prices.

**Answer: B**

The sales of most product types and brands eventually decrease permanently. This decline may be slow or rapid. This first symptom of the decline stage of a product's life cycle triggers such other effects as price cutting, narrowing of the product line, and reduction in promotion budgets.

**QUESTION: 231**

At the introduction stage of an innovative product, the profit growth is normally slow due to

- A. Expensive sales promotion.
- B. High competition.
- C. A mass market.
- D. Available alternatives.

**Answer: A**

The introduction stage is characterized by slow sales growth and lack of profits because of the high expenses of promotion and selective distribution to generate awareness of the



product and encourage customers to try it. Thus, the per-customer cost is high. Competitors are few, basic versions of the product are produced, and higher-income customers (innovators) are usually targeted. Cost-plus prices are charged. They may initially be high to permit cost recovery when unit sales are low. The strategy is to infiltrate the market, plan for financing to cope with losses, build supplier relations, increase production and marketing efforts, and plan for competition.

**QUESTION: 232**

While auditing a marketing department, the internal auditor discovered that the product life cycle model was used to structure the marketing mix. Under such a philosophy, the price charged on a consistent basis for a specific product would probably be lowest during which life cycle stage?

- A. Introduction stage.
- B. Growth stage.
- C. Maturity stage.
- D. Decline stage.

**Answer: C**

During the maturity stage, competition is at its greatest and costs are at their lowest. Moreover, firms are engaged in competitive price-cutting measures, resulting in some of the lowest prices seen during a product's life cycle.

**QUESTION: 233**

While auditing a marketing department, the internal auditor discovered that the product life cycle model was used to structure the marketing mix. Under such a philosophy, the opportunity for cost reductions would be greatest in which stage of the life cycle?

- A. Introduction stage.
- B. Growth stage.
- C. Maturity stage.
- D. Decline stage.

**Answer: B**

During the growth stage, the opportunity for cost reductions is at its maximum because production volume is increasing at a high rate. Thus, fixed costs are being spread over more units of production, and the benefits of the learning curve are being realized.

**QUESTION: 234**

While auditing a marketing department, the internal auditor discovered that the product life cycle model was used to structure the marketing mix. The manager has asked the auditor for advice about increasing advertising of various products. During which stage of the life cycle would it be appropriate to advertise that the company's product is the lowest price and best quality of all competitors?

- A. Introduction stage.
- B. Growth stage.
- C. Maturity stage.
- D. Decline stage.

**Answer: C**

The maturity stage is the ideal time for advertising lower prices and superior quality because this is the period during a product's life when competition is greatest. Due to the availability of many alternatives or substitutes, a firm has reasons to set itself apart. Because price and quality are both concerns of customers during the maturity stage, it is ideal for the firm to differentiate its product by advertising low prices and higher quality.

**QUESTION: 235**

A firm buys like-new computer equipment from bankrupt companies and resells it in foreign markets at prices significantly below those charged by competitors. The firm is

- A. Engaged in dumping.
- B. Engaged in price discrimination.
- C. Operating in a gray market.
- D. Operating in a black market.

**Answer: C**

In a gray market, products imported from one country to another are sold by persons trying to make a profit from the difference in retail prices between the two countries. In essence, the seller firm in this case was exploiting a price difference between markets.

**QUESTION: 236**

A firm ships its product to a foreign subsidiary and charges a price that may increase import duties but lower the income taxes paid by the subsidiary. The most likely reason for these effects is that the

- A. Price is an arm's-length price.
- B. Price is a cost-plus price.
- C. Transfer price is too low.

D. Transfer price is too high.

**Answer:** D

A transfer price is the price charged by one subunit of a firm to another. When the subsidiary-buyer is in a foreign country, the higher the transfer, the higher the potential tariffs. However, the tax levied on a subsequent sale by the subsidiary will be lower because of its higher acquisition cost.

**QUESTION:** 237

A global firm establishes a cost-based price for its product in each country. The most likely negative outcome is that this pricing strategy will

- A. Bet too high a price in countries where the firm's costs are high.
- B. Overprice the product in some markets and underprice it in others.
- C. Create a gray market.
- D. Result in dumping.

**Answer:** A

A firm may set a cost-based price in each market with a standard markup. In a region or country where costs are high, this strategy may result in prices that are too high to be competitive within the local market.

**QUESTION:** 238

A firm sells its product in a foreign market for a much higher price than in its home market. The reason is most likely

- A. Price elasticity of demand.
- B. Dumping.
- C. Gray market activity.
- D. Price escalation.

**Answer:** D

Price escalation is caused by an accumulation of additional costs, e.g., currency fluctuations; transportation expenses; profits earned by importers, wholesalers, and retailers; and import duties.

**QUESTION:** 239

Setting the introductory price of a new product relatively high is

- A. Market-based pricing.
- B. Price skimming.
- C. Penetration pricing.
- D. Pricing by intermediaries.

**Answer: B**

Price skimming is the practice of setting an introductory price relatively high to attract buyers who are not concerned about price and to recover research and development costs rather quickly. The opposite approach is to use penetration pricing, which involves setting a relatively low price to gain deep market penetration quickly.

**QUESTION: 240**

Price skimming involves

- A. Setting a low introductory price.
- B. Setting a high introductory price.
- C. Setting different freight charges for customers in different zones.
- D. Using markups tied closely to the price paid for a product.

**Answer: B**

Price skimming is used when a new product is introduced at the highest price possible given the benefits of the product. For market skimming to work, the product must appear to be worth its price, the costs of producing a small volume cannot be so high that they eliminate the advantage of charging more, and competitors cannot enter the market and undercut the price.

**QUESTION: 241**

Which of the following price adjustment strategies is designed to smooth production for the selling firm?

- A. Cash discounts.
- B. Quantity discounts.
- C. Functional discounts.
- D. Seasonal discounts.

**Answer: D**

Seasonal discounts are designed to smooth production by the selling firm. For example, a ski manufacturer offers seasonal discounts to retailers in the spring and summer to encourage early ordering.

**QUESTION:** 242

Company F produces and sells two products. Product A costs US \$10 per unit and Product B costs US \$5 per unit. Product A is selling very well, but sales of Product B are low. In order to increase sales of Product B, Company F has begun setting a price of US \$13 for one of each. What is the pricing method?

- A. Product-bundle pricing.
- B. By-product pricing.
- C. Value pricing.
- D. Collusive pricing.

**Answer:** A

Product-bundle pricing entails selling combinations of products at a price lower than the combined prices of the individual items. This strategy promotes sales of items consumers might not otherwise buy.

**QUESTION:** 243

Selling below cost in other countries is called

- A. Predatory pricing.
- B. Price discrimination.
- C. Dumping.
- D. Collusive pricing.

**Answer:** C

Dumping, which refers to selling below cost in other countries, is an inappropriate pricing tactic that may trigger retaliatory tariffs and other sanctions.

**QUESTION:** 244

All of the following are objectives of pricing except

- A. Image oriented objectives.
- B. Profit maximization.
- C. Stabilization.

D. Production maximization.

**Answer: D**

Pricing objectives include>

1. Profit maximization, which assumes that all firms select the price that results in the highest profit
2. Target margin maximization, which is stated as a percentage ratio of profits to sales
3. Volume-oriented objectives, which refers to setting prices to meet target sales volumes or market shares.
4. image oriented objectives, which refers to setting prices to enhance the consumer's perception of the firm's merchandise mix
5. Stabilization objectives, which refers to setting prices to maintain a stable relationship between the firm's prices and the industry leader's prices Price setting is not a factor in maximizing production.

**QUESTION: 245**

Company P, which produces computers, uses a target pricing and costing approach. The following is Company P's costs and revenues for the year just ended:

Number of computers sold	10,000
Sales price per computer	US \$1,500
Cost of goods sold	US \$8,000,000
Operating costs excluding production	US \$5,500,000

Company P plans to increase sales of computers to 15,000 in the next year by reducing the unit price to US \$1,250. If Company P wishes to achieve a unit target operating income of 10%, by what amount must it reduce the full cost per unit?

- A. US \$100
- B. US \$125
- C. US \$225
- D. US \$250

**Answer: C**

Unit target operating income is US \$125 (10% \$1,250 target price). Thus, the unit target full cost is US \$1,125 (\$1,250 - \$125). The current full cost per unit is US \$1,350 [(\$8,000,000 cost of goods sold + \$5,500,000 operating costs excluding production) ÷ 10,000 units sold], so the necessary reduction in full cost per unit is US \$225 (\$1,350 - \$1,125).

**QUESTION: 246**

Market-based pricing involves

- A. Adding a standard markup to the cost of the product.

- B. Determining the price at which the product' will earn a target profit.
- C. Basing prices on the product's perceived value.
- D. Basing prices on competitors' prices.

**Answer: C**

Market-based pricing involves basing prices on the product's perceived value rather than on the seller's cost. If price variables in the marketing mix augment the perceived value. For example, a cup of coffee may have a higher price at an expensive restaurant than at a fast food outlet.

**QUESTION: 247**

Value engineering is

- A. A policy of seeking continuous improvement in all phases of company activities.
- B. A method of determining prices based on a cost determination.
- C. An element of a marketing mix strategy.
- D. A systematic approach to assessing all aspects of cost buildup for a product.

**Answer: D**

Value engineering is a means of reaching targeted cost levels. It is a systematic approach to assessing all aspects of the value chain cost buildup for a product: R&D, design of products, design of processes, production, marketing, distribution, and customer service. The purpose is to minimize costs without sacrificing customer satisfaction.

**QUESTION: 248**

Company A is a producer of citrus flavored dessert products. Its most popular product is its key, lime pies, which are made with many fine ingredients, including egg yolks. Company A also sells the egg whites that are left over from its production process. These egg whites are sold at any price that is greater than the cost of storing and delivering them. What is the pricing of the egg whites?

- A. By-product pricing.
- B. Captive-product pricing.
- C. Product-bundle pricing.
- D. Value pricing.

**Answer: A**

By-product pricing usually sets prices at any amount in excess of storing and delivering by-products. Such prices allow the seller to reduce the costs and therefore the prices of the main products.

**QUESTION: 249**

Which of the following is a definition of predatory pricing?

- A. Pricing products below cost to destroy competitors.
- B. Pricing products at different prices for different customers.
- C. Conspiring to restrict output and set artificially high prices.
- D. Selling below cost in other countries.

**Answer: A**

Predatory pricing is the practice of pricing products below cost to destroy competitors. A price is predatory if it is below an appropriate measure of costs, and the seller has a reasonable prospect of recovering its losses in the future through higher prices or greater market share.

**QUESTION: 250**

Prices vary directly with capacity usage under

- A. Collusive pricing.
- B. Peak-load pricing.
- C. Market-based pricing.
- D. Cost-based pricing.

**Answer: B**

Under peak-load pricing, prices vary directly with capacity usage. Thus, when idle capacity is available, that is, when demand falls, the price of a product or service tends to be higher given a peak-load pricing approach.

**QUESTION: 251**

A company uses a target pricing and costing approach. The following is its costs and revenues for the current year:

Units sold	100,000
Sales price per unit	US \$10
Cost of goods sold	US \$515,000
Operating costs excluding production	US \$335,000



The company intends to increase unit sales to 120,000 in the next year by reducing the unit price to US \$8. If the company is to achieve a unit target operating income of 15%, by what amount must it reduce the full cost per unit?

- A. US \$0.50
- B. US \$1.20
- C. US \$1.50
- D. US \$1.70

**Answer: D**

Unit target operating income is US \$1.20 (15% of \$8 target price). Thus, the unit target full cost is US \$6.80 (\$8 - \$1.20). The current full cost per unit is US \$8.50 [(\$515,000 cost of goods sold + \$335,000 operating costs excluding production) ÷ 100,00 units sold], so the necessary reduction in full cost per unit is US \$1.70 (\$8.50 - \$6.80).

**QUESTION: 252**

A situation in which companies conspire to restrict output and set artificially high prices is known as:

- A. Collusive pricing.
- B. Predatory pricing
- C. Price discrimination.
- D. Market-based pricing.

**Answer: A**

Collusive pricing is illegal. It involves two or more competitors conspiring to restrict output and charge artificially high prices.

**QUESTION: 253**

A pricing strategy that sells combinations of products at a price lower than the combined prices of the individual items is

- A. Predatory pricing.
- B. Going-rate pricing.
- C. Product-bundle pricing.
- D. Captive-product pricing.

**Answer: C**

Product-bundle pricing is a strategy to promote items consumers might not otherwise buy by selling combinations of products at a price lower than the prices of the individual items combined.

**QUESTION:** 254

Which of the following statements is true with respect to value engineering?

- I. Value engineering is a means of reaching targeted cost levels.
- II. Value engineering is the Japanese concept that emphasizes continuous improvement in all phases of company activities through numerous minor changes.
- III. Value engineering requires distinguishing between cost incurrence and locked-in costs, with an emphasis on controlling costs at the design stage.

- A. Items I and II only.
- B. Items I and III only.
- C. Items II and III only.
- D. Items I, II, and III.

**Answer:** B

Value engineering is a means of reaching targeted cost levels. Value engineering requires distinguishing between cost incurrence and locked-in costs, with emphasis on controlling costs at the design stage. It is not Japanese.

**QUESTION:** 255

Company F applies a target pricing and costing approach. The following information about costs and revenues of Company F's product are available for the year just ended:

Unit sales	60,000
Unit selling price	US \$400
Cost of goods sold	US \$13,200,000
Value-chain operating costs excluding production	US \$7,920,000

Company F plans to increase unit sales to 80,000 by reducing the product's unit price to US \$320. If Company F desires a unit target operating income of 12%, by what amount must it reduce the full cost per unit?

- A. US \$32.00
- B. US \$38.40
- C. US \$70.40
- D. US \$80.00

**Answer:** C

Unit target operating income is US \$38.40 (12% of \$320 unit target price). Hence, the unit target full cost is US \$281.60 (\$320 - \$38.40). The current full cost per unit is US \$352.00 [(\$13,200,000 CGS + \$7,920,000 other value chain operating costs) ÷ 60,000 units sold], so the necessary reduction in the full cost per unit is US \$70.40 (\$352.00 - \$281.60).

**QUESTION: 256**

When film is sold for use with a camera, this is an example of which of the following product mix pricing strategies?

- A. By-product pricing.
- B. Optional product pricing.
- C. Captive product pricing.
- D. Product bundle pricing.

**Answer: C**

Captive products are those that must be used along with the main product. Sellers often make their money on the captive products, rather than on the main product that is sold at a low price. The captive products will therefore be priced well above the storage and delivery costs.

**QUESTION: 257**

A competitive marketing strategy in which a firm specializes in serving customers overlooked or ignored by major competitors is called a

- A. Market leader strategy.
- B. Market challenger strategy.
- C. Market follower strategy.
- D. Market niche strategy.

**Answer: D**

Specializing in serving customers overlooked or ignored by major competitors is a market niche strategy. This strategy specializes along market, customer, product, or marketing mix lines.

**QUESTION: 258**

Which of the following is the method of adding a standard markup to the cost of the product?

- A. Penetration pricing.
- B. Going-rate pricing.

- C. Cost-based pricing.
- D. Price skimming.

**Answer: C**

Cast-based pricing is a pricing method in which a standard markup or target profit is added to the cost of the product in determining the product's sales price.

**QUESTION: 259**

Which of the following is a false statement about cost-based pricing?

- A. Cast-based price should cover costs and provide the desired return on investment.
- B. A commonly used cost-plus pricing formula is to add a markup percentage to the total cost.
- C. Variable costs may not be used as the basis for costs.
- D. A cost-plus price equals the cost plus a markup.

**Answer: C**

Cast-based pricing begins with a cost determination followed by setting a price that will recover the value chain costs and provide the desired return on investment. A cost-plus price equals the cost plus a markup. Cost may be defined in many ways. First, companies use either absorption manufacturing cost or total cost when calculating the price. Variable costs may be used as the basis for cost, but then fixed costs must be covered by the markup.

**QUESTION: 260**

Evaluating performance is not done to

- A. Determine the amount of nondiscriminatory benefits that each employee deserves.
- B. Assess the available human resources of the firm.
- C. Motivate the employees.
- D. Determine which employees deserve salary increases.

**Answer: A**

Evaluations reinforce accomplishments, help in assessing employee strengths and weaknesses, provide motivation, assist in employee development, permit the organization to assess its human resource needs, and serve as a basis for wage increases. First, nondiscriminatory benefits are given to everyone in the organization in equal amounts, regardless of title, pay, or achievement of objectives.

**QUESTION: 261**

When a manager generalizes from the evaluation of one or a few traits to the employee's total performance, s)he has made

- A. A judgmental evaluation.
- B. An evaluation subject to the halo effect.
- C. A projection.
- D. An objective evaluation

**Answer: B**

The halo effect occurs when the appraiser judges one or a few employee traits and carries over this judgment to the evaluation of the employee's other traits. The converse of the halo effect is the horn effect. It occurs when the manager allows one negative trait to influence the evaluation of other traits.

**QUESTION: 262**

A manager discovers by chance that a newly hired employee has strong beliefs that are very different from the manager's and from those of most of the other employees. The manager's best course of action would be to

- A. Facilitate the reassignment of the new hire as quickly as possible before this situation becomes disruptive.
- B. Ask the rest of the team for their reaction and act according to the group consensus.
- C. Take no action unless the new hire's behavior is likely to cause harm to the organization.
- D. Try to counsel the new hire into more reasonable beliefs.

**Answer: C**

The only legitimate grounds on which the supervisor may take action is the employee's behavior. Personal beliefs, such as those on religious and political matters, cannot be the basis of personnel actions. Discrimination on the basis of personal beliefs could expose the organization to legal action.

**QUESTION: 263**

A company allows each of its departments to develop its own system for evaluating performance. How should the personnel director communicate appraisal information to a new employee?

- A. Presenting anything that is pertinent to the listener's situation.
- B. Providing an overview of all systems within the company.
- C. Describing how her own performance is evaluated.

D. Discussing each department's evaluation system in detail.

**Answer: A**

The personnel director should tailor the discussion to the listener by describing how the employee's department evaluates performance and what is expected of him/her. The director should also obtain feedback from the employee to determine if everything is clearly understood.

**QUESTION: 264**

A disadvantage of separating performance evaluations from compensation-increase decisions is that

- A. Not enough emphasis is placed on short-run performance.
- B. Financial rewards may lose their motivational effect.
- C. Employees may not be motivated by good appraisals.
- D. The employee's performance evaluation does not consider the financial status of the company overall.

**Answer: C**

The employee may not be motivated immediately by a good appraisal because of the delay in receipt of any monetary reward. The evaluation also may not be taken as seriously by the employee if compensation is not correlated with performance.

**QUESTION: 265**

A company that wishes to improve its rate of retention of its experienced employees might

- A. Abolish its hire-from-within policy.
- B. Improve its fringe benefit package.
- C. Initiate job simplification programs.
- D. Set a mandatory retirement age.

**Answer: B**

Fringe benefits e.g., pensions and profit-sharing plans) may be contingent on duration of employment. Accordingly, they motivate employees to remain with the company.

**QUESTION: 266**

The value of retaining employees is determined by

- A. Human asset accounting.
- B. Financial accounting.
- C. Cost accounting.
- D. Human resource planning.

**Answer:** A

Human resource or human asset accounting attempts to measure the value, and the changes in value, of the organization's investment in human assets. Although this "asset" is enormously valuable sometimes estimated at two or three times the annual payroll), it is not shown in balance sheets or accounted for in earnings statements. One experimental measurement approach is a "present value" of human resources. Another is a "cost" approach, with financial investments training, customer goodwill, etc.) offset by reductions e.g., retirement).

**QUESTION:** 267

Which of the following methods of employee evaluation is best used when employees are heavily involved in teamwork?

- A. 360-degree performance appraisal.
- B. Attribution method.
- C. Critical incident technique.
- D. Behaviorally anchored rating scales BARS)

**Answer:** A

The 360-degree performance appraisal is a model for employee assessment in the age of teamwork. It is based on giving workers feedback from peers, customers, supervisors, and those who work for the employee. Feedback is typically provided anonymously and is usually subjective.

**QUESTION:** 268

If a supervisor fails to give an employee a negative evaluation because of fear of damaging a good working relationship, this is known as the

- A. Leniency error.
- B. Recency effect.
- C. Halo effect.
- D. Contrast error.

**Answer: A**

A leniency error is a manager's failure to give a negative evaluation because of fear of damaging a good working relationship with an employee.

**QUESTION: 269**

An evaluator is rating 100 employees on a bell curve. She is instructed to label five employees "extraordinary" and five employees "unsatisfactory." The evaluator also is instructed to label 10 employees "above average" and 10 employees "below average." All of the other employees will be in the "average" category. Which of the following is the major drawback of using this method?

- A. The process of using the method is too time consuming
- B. An employee's evaluation will depend on who the evaluator is.
- C. Different evaluators have different standards.
- D. The evaluator must place some employees in the lowest and highest tails of a bell-shaped curve.

**Answer: D**

The forced normal distribution method forces evaluators to label employees with ratings that fall along the normal distribution of a bell-shaped curve. The major drawback of this method is that the employees will be labeled with an evaluation regardless of their abilities. No matter what, some people will be evaluated at the bottom of the normal distribution and some people will be evaluated at the top of the normal distribution.

**QUESTION: 270**

An organization has a compensation system for its managers based on a management-by-objectives (MBO) approach. The essential premise of MBO is that

- A. Compensation should be based on qualitative factors.
- B. Employees should be concerned with routine matters, and managers should attend to exceptions.
- C. Employees should participate in setting objectives.
- D. Managers should establish objectives for their employees.

**Answer: C**

MBO involves mutual setting of objectives by the superior and the subordinate as a basis for performance evaluation. Based on the Theory of philosophy that employees want to work hard if they know what is expected, MBO requires 1) senior management participation and commitment to the program, 2) integration of the objectives for all subunits into a compatible system directed toward accomplishment of organizational objectives, 3) provision for regular



reporting of performance, and 4) free and honest communication between superior and subordinates. Subordinates must make careful assessments of their abilities and their interests, and managers must "coach" subordinates rather than dictate their proper objectives. Both sides must maintain flexibility to accommodate unforeseen changes, and the review and analysis of results before setting the next round of objectives is a vital part of the process.

**QUESTION: 271**

When faced with the problem of filling a newly created or recently vacated executive position, organizations must decide whether to promote from within or to hire an outsider. One of the disadvantages of promoting from within is that

- A. Internal promotions can have negative motivational effect on the employees of the firm.
- B. Internal promotions are more expensive to the organization than hiring an outsider.
- C. It is difficult to identify proven performers among internal candidates.
- D. Hiring an insider leads to the possibility of social inbreeding within the firm.

**Answer: D**

Hiring an internal candidate can lead to social inbreeding. Many firms look to external candidates for certain jobs because they bring a fresh perspective to the organization's problems and may have more up-to-date training or education.

**QUESTION: 272**

Questions about which of the following can legally be asked in recruiting interviews?

- A. Age.
- B. Number of children.
- C. Kind of military discharge.
- D. Criminal record but only for security clearance purposes)

**Answer: D**

In a recruiting interview, one may not ask about the applicant's marital status, number of children, height and weight, criminal record except for the purpose of giving a security clearance), kind of military discharge, or age.

**QUESTION: 273**

The halo effect may diminish the accuracy of the evaluation of employees. Which of the following is an example?

- A. A manager rates some employees as very good and some as very poor.
- B. A manager's judgment of one positive trait affects his/her rating of other traits.
- C. The most recent behavior overshadows overall performance.
- D. All personnel who work together are rated within the same narrow range.

**Answer: B**

The halo effect diminishes the accuracy of an evaluation when a manager's judgment on one positive trait affects the rating of other traits.

**QUESTION: 274**

Which of the following is not a characteristic of an effective evaluation system?

- A. Relevant.
- B. Significant
- C. Unbiased.
- D. Highly structured.

**Answer: D**

The system should be relevant, unbiased, significant, and practical. The evaluation system should be as objective, easy to use, clearly understood, and efficient as possible, but it is not necessary that it be highly structured.

**QUESTION: 275**

Which of the following hiring procedures provides the most control over the accuracy of information submitted on an employment application?

- A. Applicants are required to submit unofficial copies of their transcripts along with the application as verification of their educational credentials.
- B. The hiring organization calls the last place of employment for each finalist to verify the employment length and position held.
- C. Letters of recommendation that attest to the applicants character must be mailed directly to the hiring organization rather than being submitted by the applicant.
- D. Applicants are required to sign a statement that the information on the application is true and correct as a confirmation of its truth.

**Answer: B**

Calling the last place of employment for candidates to verify information represents an independent verification of employment. The hiring organization is performing the verification process.

**QUESTION:** 276

Performance appraisal systems might use any of three different approaches: 1) who did the job, 2) how the job was done, or 3) what was accomplished. Which approach is used by a system that places the focus on how the job was done?

- A. Behavior-oriented.
- B. Goal-oriented.
- C. Trait-oriented.
- D. Employee-oriented.

**Answer:** A

Behavior-oriented performance evaluation rewards the behavior that is desired by management. Behavior control involves examining work processes rather than work output.

**Section 1:** Sec One (1 to 163)

**Details:** Business performance

**QUESTION: 1**

The measurement basis most often used to report a long-term payable representing a commitment to pay money at a determinable future date is

- A. Historical cost.
- B. Current cost.
- C. Net realizable value
- D. Present value of future cash flows.

**Answer: D**

The measurement basis most commonly adopted by entities in preparing their financial statements is historical cost. However, it is usually combined with other measurement bases (attributes). The attribute used to measure a long-term receivable or payable is the present or discounted value of its future cash flows.

**QUESTION: 2**

In December Year 1 catalogs were printed for use in a special promotion in January Year 2. The catalogs were delivered by the printer on December 13, Year 1 with an invoice for US \$70,000 attached. Payment was made in January Year 2. The US \$70,000 should be reported as a deferred cost at the December 31, Year 1, balance sheet date because of the

- A. Matching principle.
- B. Revenue recognition principle.
- C. Reliability principle.
- D. Cost principle

**Answer: A**

Matching is the simultaneous or combined recognition of revenues and expenses resulting directly and jointly from the same transactions or other events. Expenses should be associated with the revenues that they help to create. Because the catalogs are still on hand at the balance sheet date, they will not contribute to an inflow of economic benefits until the next period. Hence, the cost should be deferred and matched with the revenues of the following period.

**QUESTION: 3**

Because of inexact estimates of the service life and the residual value of a plant asset, a fully depreciated asset was sold in the current year at a material gain. This gain most

likely should be reported

- A. In the other revenues and gains section of the current income statement
- B. As part of sales revenue on the current income statement
- C. In the extraordinary item section of the current income statement.
- D As an adjustment to prior periods' depreciation on the statement of changes in equity\_

**Answer: A**

Income includes revenue and gains. Their essential nature is the same, and they are not treated as separate financial statement elements. Revenues occur in the course of ordinary activities. Gains may or may not occur in the course of ordinary activities. For example, gains may occur from the sale of noncurrent assets. Thus, the gain on the sale of a plant asset is not an operating item and should be classified in an income statement with separate operating and nonoperating sections in the other revenues and gains section.

**QUESTION: 4**

Assume that employees confessed to a US \$500,000 inventory theft but are not able to make restitution. How should this material fraud be shown in the company's financial statements?

- A. Classified as a loss and shown as a separate line item in the income statement.
- B. Initially classified as an accounts receivable because the employees are responsible for the goods. Because they cannot pay, the loss would be recognized as a write-off of accounts receivable.
- C. Included in cost of goods sold because the goods are not on hand, losses on inventory shrinkage are ordinary, and it would cause the least amount of attention.
- D. Recorded directly to retained earnings because it is not an income-producing item

**Answer: A**

Expenses include losses. Their essential nature is the same, and they are not treated as separate financial statement elements. Losses may or may not occur in the course of ordinary activities. For example, they may result from nonreciprocal transactions (e.g., theft), reciprocal transactions (e.g., a sale of plant assets), or from holding assets or liabilities. Losses are typically displayed separately.

**QUESTION: 5**

The assets of a liquidating entity should be shown on the balance sheet at their

- A. Undepreciated historical cost.

- B. Fair value
- C Realizable value.
- D. Current cost.

**Answer: C**

When liquidation is imminent, and the going concern assumption is no longer valid, the most appropriate measurement attribute for assets is realizable value. which is the amount of cash currently obtainable by sale in an orderly disposal.

**QUESTION: 6**

An objective of financial reporting is

- A. Providing information useful to investors, creditors, donors, and other users for decision making.
- B. Assessing the adequacy of internal control.
- C. Evaluating management results compared with standards.
- D. Providing information on compliance with established procedures.

**Answer: A**

The objectives of financial reporting are concerned with the underlying goals and purposes of accounting. They are to provide information that1) is useful to those making investment and credit decisions, assuming that those individuals have a reasonable understanding of business and economic activities;2) is helpful to current and potential investors and creditors and other users in assessing the amount, timing, and uncertainty of future cash flows; and3) discloses economic resources, claims to those resources, and the changes therein.

**QUESTION: 7**

The amortization of intangible assets with finite useful lives is justified by the

- A. Economic entity assumption.
- B. Going concern assumption.
- C. Monetary unit assumption
- D. Historical cost assumption

**Answer: B**

Every business is assumed to be a going concern that will continue operating indefinitely. Thus, liquidation values are not important. For example, if an entity is not a going concern, its intangible assets are reported at liquidation values, not at historical cost net of

amortization.

**QUESTION: 8**

An entity with total assets of US \$100,000,000 and profit of US \$10,000,000 purchases staplers with an estimated life of 10 years for US \$1,000. In connection with the purchase, the company debits miscellaneous expense. This scenario is most closely associated with which of the following concepts or principles?

- A. Materiality and going concern.
- B. Relevance and neutrality.
- C. Reliability and comparability.
- D. Materiality and the balance between cost and benefit.

**Answer: D**

In principle, wasting assets should be capitalized and depreciated. However, the effect on the financial statements of expensing rather than capitalizing and depreciating the staplers is clearly not material given that they cost US \$1,000 and the enterprise has total assets of US \$100,000,000. The choice of treatment is not likely to influence the decisions of financial statement users. The balance between benefit and cost is a pervasive constraint, not a qualitative characteristic. The benefits should exceed the cost of information. Specifically, the cost of producing the information about depreciation expense over 10 years for the staplers probably is higher than the benefits of the information for decision making. Thus, the expedient procedure of expensing the US \$1,000 should be followed.

**QUESTION: 9**

To comply with the matching principle, the cost of labor services of an employee who participates in the manufacturing of a product normally should be charged to the income statement in the period in which the

- A. Work is performed.
- B. Employee is paid.
- C. Product is completed.
- D. Product is sold.

**Answer: D**

Recognition of expenses occurs concurrently with recognition of increases in liabilities or decreases in assets. Expenses are recognized if the costs are directly associated with the earning of particular income items. This process is often called matching. Matching is simultaneous or combined recognition of the revenues and that result directly and jointly from the same transactions or other events. This direct relationship is exemplified by the

sale of a product. This transaction results in revenuesales revenue) for receipt of cash or a receivable, the recognition of an expenscost of sales) for the sacrifice of the product to a customer, and a decrease in inventory. The direct labor cost of manufacturing the product is absorbed by the finished goods inventory and is not recognized until sale.

**QUESTION: 10**

In recording transactions, which of the following best describes the relation between expenses and losses?

- A. Losses are extraordinary charges to income, whereas expenses are ordinary charges to income.
- B. Losses are material items, whereas expenses are immaterial items.
- C. Losses are expenses that may or may not arise in the course of ordinary activities.
- D. Expenses can always be prevented, whereas losses can never be prevented.

**Answer: C**

Expenses are defined as "decreases in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrences of liabilities that result in decreases in equity, other than those relating to distributions to equity participants." Expenses include losses. Thus, losses are not treated as separate elements. Expenses include items arising in the course of ordinary activities. Losses meet the definition of expenses but may or may not occur in the course of ordinary activities. For example, losses may result from the sale of noncurrent assets or from natural disasters.

**QUESTION: 11**

Which of the following is a noncash item?

- A Administrative expense.
- B. Interest expense.
- C. Income tax expense.
- D. Depreciation expense.

**Answer: C**

Expenses are defined as decreases in economic benefits during the accounting period in the forum of outflows or depletions of assets or incurrences of liabilities that result in decreases in equity, other than those relating to distributions to equity participants." Expense includes losses. Thus, losses are not treated as separate elements. Expenses include items arising in the course of ordinary activities. Losses meet the definition of expenses but may or may not occur in the course of ordinary activities. For example, losses may result from the sale of noncurrent assets of from natural disasters.



**QUESTION: 12**

A service entity keeps its accounting records on a cash basis. During the recent year, the entity collected US \$600,000 from customers. The following information is also available:

	Beginning of Year	End of Year
Accounts receivable	US \$120,000	US \$180,000
Unearned revenue	0	15,000

What was the amount of service revenue for the year on an accrual basis?

- A. US \$525.000
- B. US \$555,000
- C. US \$645.000
- D. US \$675.000

**Answer: C**

The amount of service revenue for the year on an accrual basis equals US \$645,000 (\$600,000 cash collected - \$15,000 unearned revenue + \$60,000 increase in accounts receivable).

**QUESTION: 13**

The correct order of the following steps of the accounting cycle is

- A. Posting, closing, adjusting, reversing.
- B. Posting, adjusting, closing, Reversing
- C. Posting, reversing, adjusting, closing.
- D. Adjusting, posting, closing, Reversing

**Answer: B**

The order of the steps in the accounting cycle is identification and measurement of transactions and other events required to be recognized, journalization, posting from the journals to the ledgers, the development of a trial balance, adjustments to produce an adjusted trial balance, statement presentation, closing, taking a postclosing trial balance (optional), and making reversing entries (optional).

An entity is in the equipment rental business. Part of its unadjusted trial balance at December 31 is as follows:

Cash	US \$ 17,400
Prepaid insurance	3,600
Property, plant, and equipment	180,000
Accumulated depreciation	32,000
Accounts payable	12,000
Share capital	60,000
Retained earnings	38,000
Rental revenue	171,000
Salaries and wages expense	80,000
Utilities expense	14,000

On October 1, year 1, the entity paid US\$ 18,000 to renew its only insurance policy for a 3-year period beginning on that date. This transaction has not been recorded. Salaries and wages of US\$1,700 have been incurred but not paid as of December 31, year 1. At December 31, year 1, the balance per bank statement was US\$12,000. Outstanding checks amounted to US \$,900. Interest of US \$40 was credited to the entity's account by the bank during December, but has not yet been entered on the books.

**QUESTION: 14**

What amounts should be reported for prepaid insurance and insurance expense in the annual financial statements prepared at December 31?

	<u>Prepaid Insurance</u>	<u>Insurance Expense</u>
A.	US \$16,500	US \$1,500
B.	US \$16,500	US \$5,100
C.	US \$18,000	US \$3,600
D.	US \$20,100	US \$1,500

**Answer: B**

The insurance policy in effect at the beginning of the year expired and was renewed during the year. Hence, the entire US \$3,600 beginning balance in the prepaid insurance account should be expensed. The amount of the prepayment on the new policy to be expensed is US \$1,500 [3 months elapsed x \$18,000 ÷ 36-month duration of the policy]. The debit balance in prepaid insurance at year-end is therefore US \$16,500 (\$18,000 - \$1,500), and total insurance expense is US \$5,100 (\$3,600 + \$1,500).

**QUESTION: 15**

The required adjusting entry at December 31 related to salaries and wages is

- A. Salaries & wages expense US \$1,700  
Income summary US \$1,700
- B. Salaries & wages payable US \$1,700

Salaries & wages expense US \$1,700  
 C. Salaries & wages expense US \$1,700  
 Salaries & wages payable US \$1,700  
 D. Income summary US \$1,700  
 Salaries & wages payable US \$1,700

**Answer: C**

An expense incurred but not yet paid is an accrued expense. The adjusting entry to record an accrued expense of US \$1,700 for unpaid salaries and wages is to debit an expense account and credit a liability account.

**QUESTION: 16**

The journal entry required to close the utilities expense account is

- A. Utilities expense US \$1,400  
Income summary US \$1,400
- B. Income Summary US \$1,400  
Utilities expense US \$1,400
- C. Rental expense US \$1,400  
Utilities expense US \$1,400
- D. Utilities expense US \$1,400  
Retained earnings US \$1,400

**Answer: B**

All income statement account balances are closed either to a summary accountsuch as income summary or revenue and expense summary) or to retained earnings. The normal balance of an expense account is a debit. Thus, an expense account is credited in a closing entry.

**QUESTION: 17**

An entity has made all necessary adjusting entries and is now closing its accounts for the period. Dividends of US 1 ...x!.000 were declared and distributed during the year. The entry to close the dividends account would be

- A. Retained earnings US \$30,000  
Dividends US \$30,000
- B. Dividends US \$30,000  
Retained earnings US \$30,000
- C. Income Summary US \$30,000  
Dividends US \$30,000

D. Dividends US \$30,000  
Income Summary US \$30,000

**Answer: A**

Assuming an account entitled "dividends" or "dividends declared" is debited when dividends payable is credited on the declaration date, it must be closed at the end of the period. The balance in this account is closed directly to retained earnings. The effect of declaring and paying dividends is to reduce retained earnings, so the entry is a debit to retained earnings and a credit to dividends.

**QUESTION: 18**

Which of the following statements is the best description of reversing entries?

- A. The recording of reversing entries is a mandatory step in the accounting cycle.
- B. Reversing entries are made at the end of the next accounting period, after recording regular transactions of the period.
- C. Reversing entries are identical to the adjusting entries made in the previous period.
- D. Reversing entries are the exact opposite of the adjustments made in the previous period.

**Answer: D**

Reversing entries are made at the beginning of a period to reverse the effects of adjusting entries made at the end of the preceding period. They are optional entries made for the sake of convenience in recording the transactions of the period. In order for reversing entries to reverse the prior adjustments, they must be the exact opposite of the adjustments made in the previous period.

**QUESTION: 19**

The relationship between the present value of a future sum and the future value of a present sum can be expressed in terms of their respective interest factors. If the present value of US \$200,000 due at the end of 8 years, at 10%, is US \$93,300, what is the approximate future value of US \$200,000 invested for the same length of time and at the same rate?

- A. US \$93,300
- B. US \$200,000
- C. US \$293,300
- D. US \$428,724

**Answer: D**

The interest factor for the future value of a present sum is equal to the reciprocal of the interest factor for the present value of a future sum. Thus, the future value is US \$428,724  $[(\$200,000 \div \$93,300) \times \$200,000]$ .

**QUESTION: 20**

Risoner Company plans to purchase a machine with the following conditions:

- Purchase price = US \$300,000
- The down payment = 10% of purchase price with remainder financed at an annual interest rate of 16%. The financing period is 8 years with equal annual payments made every year.
- The present value of an annuity of US \$1 per year for 8 years at 16% is 4.3436.
- The present value of US \$1 due at the end of 8 years at 16% is 0.3050

The annual payment (rounded) is

- A. US \$39,150
- B. US \$43,200
- C. US \$62,160
- D. US \$82,350

**Answer: C**

The periodic payment is found by dividing the amount to be accumulated (US \$300,000 price - \$30,000 down payment = US \$270,000) by the interest factor for the present value of an ordinary annuity for 8 years at 16%. Consequently, the payment is US \$62,160  $(\$270,000 \div 4.3436)$ .

**QUESTION: 21**

On March 15, Year 1, Kathleen Corp. adopted a plan to accumulate US \$1,000,000 by September 1, Year 5. Kathleen plans to make four equal annual deposits to a fund that will earn interest at 10% compounded annually. Kathleen made the first deposit on September 1, Year 1. Future value and future amount factors are as follows:

Future value of US \$1 at 10% for four periods 1.46

Future amount of ordinary annuity of US \$1

at 10% for four periods 4.64

Future amount of annuity in advance of US \$1

at 10% for four periods 5.11

Kathleen should make four annual deposits (rounded) of

- A. US \$250,000
- B. US \$215,500
- C. US \$195,700

D. US \$684,930

**Answer: C**

The depositor wishes to have US \$1,000,000 at the end of a 4-year period (from Year 1 to Year 5). The amount will be generated from four equal annual payments (an annuity) to be made starting at the beginning of the 4-year period. The annual payment for this annuity can be calculated in advance by dividing the desired future amount of US \$1,000,000 by the factor for the future amount of an amount in advance of US \$1 at 10% for four periods. Each annual deposit should therefore equal US \$195,700 (\$1,000,000 ÷ 5.11).

**QUESTION: 22**

If the amount to be received in 4 years is US \$137,350, and given the correct factor from the 10% time-value-of-money table below, what is the current investment?

Interest Factors for 10%				
Periods	FV	PV	FV of Ordinary Annuity	PV of Ordinary Annuity
1	1.1000	.9091	1.0000	.9091
2	1.2100	.8264	2.1000	1.7355
3	1.3310	.7513	3.3100	2.4869
4	1.4641	.6830	4.6410	3.1699
5	1.6105	.6029	6.1051	3.7908

- A. US \$30,034.33
- B. US \$43,329.44
- C. US \$93,810.05
- D. US \$201,094.14

**Answer: C**

The current investment is the present value of the given future amount. It equals the future amount multiplied by the factor for the present value of US \$1 for four periods at 10%. Accordingly, the current investment is US \$93,810.05 (\$137,350 × .6830).

**QUESTION: 23**

Which is the correct order of the following four steps in the accounting cycle?

- Step 1 Prepare adjusting journal entries
- Step 2 Take a post-closing trial balance
- Step 3 Prepare an adjusted trial balance
- Step 4 Prepare reversing entries

- A. 1, 3, 2, 4

- B. 4, 1, 3, 2
- C. 3, 1, 2, 4
- D. 1, 2, 3, 4

**Answer: A**

The accounting cycle may be summarized as consisting of nine steps: record the period's transactions in the appropriate journals, post to the ledger(s) from the journals, prepare an unadjusted trial balance, prepare and post adjusting journal entries, prepare an adjusted trial balance, prepare the financial statements, prepare and post the closing entries. take a post-closing trial balance. and prepare reversing entries(optional). On January 1, a new landscaping firm. Bandit Co. acquired a fleet of vehicles, all the necessary tools and equipment. and a parking and storage facility. It began operations immediately. It is now the end of the first year of operations, and the first set of year-end financial statements are being prepared. Several decisions have to be made regarding the appropriate accounting and reporting practices for this company. Relevant information for several of these items is described in the following list of transactions and events:

At year-end. the parking and storage facility that was purchased for US \$150,000 has a fair value of US \$250,000. The physical flow of inventory is first in. first out, and the cost of materials has risen steadily over the year. To promote sales for the coming year. maintenance contracts were sold in December at very reasonable prices, provided that the customers paid cash. On April 1, the company arranged a US \$100,000. 10% bank loan. Interest payments of US \$5,000 are due on October 1 and April 1 of each year during the 5-year term of the loan. During the first year of operations, the company experienced a 5% bad debt rate on credit sales. None of the bad debts are expected to be recovered, given that 5% is the industry average level of bad debts. Total credit sales for the year were US \$400,000. The year-end balance of accounts receivable includes uncollected overdue accounts of US \$100,000. Half of the uncollected overdue amounts are estimated to be uncollectible.

**QUESTION: 24**

If Bandit Co. reports expenses on an accrual basis, interest expense for the first year of operations is

- A. US \$5,000
- B. US \$7,500
- C. US \$10,000
- D. US \$12,500

**Answer: B**

Interest expense for the first year equals the US \$5,000 payment made on October 1 plus the 3 months' accrued interest at year-end, or US \$7,500 (\$5,000 + \$2,500).

**QUESTION: 25**

To calculate net sales. List A must be ,List B cash receipts from customers.

	List A	List B
A.	An increase in accounts receivable	Added to
B.	An increase in accounts receivable	Subtracted from
C.	An increase in accounts payable	Added to
D.	An increase in accounts payable	Subtracted from

**Answer: A**

To convert from the cash basis (cash receipts) to the accrual basis (net sales), the increase in net accounts receivable must be added to cash receipts from customers.

**QUESTION: 26**

Which of the following steps in the accounting cycle is completed later than the others?

- A. Adjustments.
- B. Journalization
- C. Posting.
- D. Identification and measurement of transactions.

**Answer: A**

The order of the steps in the accounting cycle is identification and measurement of transactions and other events required to be recognized, journalization, posting from the journals to the ledgers, the development of a trial balance, adjustments to produce an adjusted trial balance, statement presentation, closing, taking a post-closing trial balance (optional), and making reversing entries (optional).

**QUESTION: 27**

A company purchased US \$50,000 worth of office supplies on January 1st and had US \$15,000 of office supplies still on hand at year-end. If the initial purchase of supplies entry on January 1st was to debit office supplies expense and to credit cash for US \$50,000, the adjusting entry on December 31 will be

- A. Office supplies US \$15,000  
Office supplies dividends US \$15,000
- B. Office supplies dividends US \$15,000  
Office supplies US \$15,000
- C. Office supplies US \$35,000  
Office supplies dividends US \$35,000



D. Office supplies expense US \$35,000  
Office supplies US \$35,000

**Answer: A**

Because the initial entry recorded the entire purchase to a nominal account, the year-end adjusting entry must debit a prepaid asset to reflect the remaining supplies on hand of US \$15,000. The adjusting entry must also credit (reduce) expenses for the US \$15,000 of supplies that were not used during the period.

**QUESTION: 28**

The present value of US \$100,000 due at the end of eight years, at 10%, is US \$46,650. What is the approximate value of US \$100,000 invested for the same length of time and at the same rate?

- A. US \$46,650
- B. US \$100,000
- C. US \$114,360
- D. US \$214,360

**Answer: D**

The present value of a future amount equals that amount divided by the interest factor for the given discount period and discount rate. The interest factor for the present value of 1 due in 8 years and discounted at 10% is 2.1436 (US \$100,000 ÷ \$46,650). Thus the future value of US \$100,000 must be US \$214,360 (US \$100,000 × 2.1436).

**QUESTION: 29**

A company purchased a new machine on an installment payment plan and is to make equal annual payments beginning one year from the date of purchase. Using an interest rate of 10%, the cost of the machine can be determined by multiplying one payment by the

- A. Future value of one currency unit.
- B. Future value of an annuity due of one currency unit.
- C. Present value of one currency unit.
- D. Present value of an ordinary annuity of one currency unit.

**Answer: D**

The cost of the machine is the present value of the annuity (the series of equal periodic payments). The annuity is an ordinary annuity because the payments begin one period

after the date of purchase. The cost therefore equals the periodic payment times the interest factor for an ordinary annuity of one currency unit for a specified number of equal periodic payments discounted at a given interest rate.

**QUESTION: 30**

The purpose of an entry that contains a debit to prepaid property taxes and a credit to property tax expense is to recognize a(n)

- A. Prepaid expense.
- B. Accrued expense.
- C. Prepaid income.
- D. Expired cost.

**Answer: A**

An entry debiting prepaid property taxes and crediting property tax expense is needed at the balance sheet date when prepayments are initially recorded in an expense account. This adjusting entry defers expense recognition to the future period in which the property taxes apply.

**QUESTION: 31**

What are the effects of an adjusting entry used to accrue revenue from credit sales?

	<u>Assets</u>	<u>Liabilities</u>	<u>Equity</u>
A.	Decrease	No effect	Decrease
B.	Increase	No effect	Increase
C.	No effect	Decrease	Increase
D.	No effect	Increase	Decrease

**Answer: B**

The journal entry to accrue revenue requires a debit to a receivable account and a credit to a revenue account. Thus, the accrual of revenue increases assets and equity.

**QUESTION: 32**

The practice of recording advance payments from customers as a liability is an example of applying the

- A. Going concern assumption.
- B. Monetary unit assumption.
- C. Historical cost principle.
- D. Revenue recognition principle.

**Answer: D**

Recognition of revenue occurs when the flow of future economic benefits to the enterprise is probable and such benefits are reliably measurable. Recording advance payments as a liability reflects a determination that the receipt of future economic benefits is not sufficiently certain to merit revenue recognition, given that the enterprise has not yet performed its obligations.

**QUESTION: 33**

An entity sells a durable good to a customer on January 1, Year 1, and the customer is automatically given a 1-year warranty. The customer also buys an extended warranty package extending the coverage for an additional 2 years to the end of Year 3. At the time of the original sale, the company expects warranty costs to be incurred evenly over the life of the warranty contracts. The customer has only one warranty claim during the 3-year period, and the claim occurs during Year 2. The company will recognize income from the sale of the extended warranty

- A. On January 1, Year 1
- B. In Year 2 and Year 3.
- C. At the time of the claim in Year 2.
- D. December 31, Year 3, when the warranty expires.

**Answer: B**

Because warranty costs are expected to be incurred evenly over the life of the warranty contracts, the income should be recognized on the straight-line basis over the life of the extended warranty contract.

**QUESTION: 34**

An entity had cash receipts from sales of US \$175,000 during year 2, of which US \$30,000 was unearned at the end of Year 2. At the end of Year 1, the company had US \$40,000 of deferred revenue, all of which was earned in Year 2. The company's sales revenue for Year 2 would be

- A. US \$145,000
- B. US \$165,000
- C. US \$175,000
- D. US \$185,000

**Answer: D**

The sales revenue earned in Year 2 equals Year 2 cash receipts, minus any receipts in

Year 2 for which the revenue was deferred, plus the revenue earned from cash receipts in Year 1. or US \$185,000\$175,000 - \$30,000 \$40,000).

**QUESTION: 35**

ABC operates a catering service that specializes in business luncheons for large corporations. ABC requires customers to place their orders 2 weeks in advance of the scheduled events. ABC bills its customers on the tenth day of the month following the date of service and requires that payment be made within 30 days of the billing date. Conceptually, ABC should recognize revenue from its catering services at the date when a

- A. Customer places an order.
- B. Luncheon is served.
- C. Billing is mailed.
- D. Customer's payment is received.

**Answer: B**

Income, which includes revenue and gains, should not be recognized until an increase in future economic benefits related to an increase in an asset or a decrease in a liability is sufficiently certain and can be measured reliably. The most common time at which these two conditions are met is when the product or merchandise is delivered or services are rendered to customers. Thus, the entity has substantially accomplished what it must do to be entitled to future economic benefits when it serves the luncheon. It should then accrue a receivable and revenue.

**QUESTION: 36**

If sales are accounted for using the installment method, which of the following is(are) only recognized in proportion to the cash collected on the sales during the period?

- A Sales.
- B Sales and cost of sales.
- C. Sales and cost of sales and selling expenses.
- D Sales and cost of sales and administrative expenses.

**Answer: B**

Under the installment method, the gross profit on sales (sales - cost of sales) is not recognized until cash is collected. The proportion of cash collected on the sales during the accounting period determines the proportion of the gross profit on those sales that is recognized during the period. Hence, both sales and cost of sales are deferred.

**QUESTION: 37**

Using the cost-recovery method of revenue recognition, profit on an installment sale is recognized

- A. On the date of the installment sale.
- B. In proportion to the cash collections.
- C. After cash collections equal to the cost of goods sold have been received.
- D. On the date the final cash collection is received.

**Answer: C**

Under the cost-recovery method, no revenue is recognized until cash payments by the buyer exceed the seller's cost of the merchandise sold. This method is appropriate when collection of the revenue is very uncertain.

**QUESTION: 38**

On February 1, Year 1, a computer software firm agrees to program a software package. Twelve payments of US \$10,000 on the first of each month are to be made, with the first payment March 1, Year 1. The software is accepted by the client June 1, Year 2. How much Year 1 revenue should be recognized?

- A. US \$0
- B. US \$100,000
- C. US \$110,000
- D. US \$120,000

**Answer: A**

Recognition of an element of financial statements (e.g., income, which includes revenue and gains) requires that two criteria be met. It must be probable that any future economic benefit associated with the item will flow to or from the entity, and the cost or value of the item must be measurable with reliability. The usual procedures for income recognition, e.g., that income be earned, reflect these criteria. Thus, income is recognized when an increase in future economic benefits is associated with an increase in an asset or a decrease in a liability. However, the entity has not substantially completed what it must do to be entitled to the benefits represented by the advance payment, and the receipt of future economic benefits is not sufficiently certain to merit income recognition. Accordingly, a liability should be recognized because the entity has a current obligation arising from a past event that will require an outflow of economic benefits, that is, to deliver the software or to refund the customer's money. Thus, a liability for US \$100,000 and revenue of US \$0 should be recognized for Year 1.

NOTE: This analysis assumes that the sale of the software is a sale either of goods or of

services for which the appropriate conditions have not been met. Under IRS 18. Revenue Recognition, revenue is recognized for a sale of goods when the entity has transferred the significant risks and rewards of ownership, the entity has neither continuing managerial involvement to a extent associated with ownership nor effective control over the goods, the amount can be reliably measured, it is probable that the economic benefits will flow to the entity, and transaction costs can be reliably measured. For a sale of services, revenue is recognized when revenue can be reliably measured, it is probable that the economic benefits will flow to the entity, the stage of completion can be reliably measured, and the costs incurred and the costs to complete can be reliably measured.

**QUESTION: 39**

A building contractor has a fixed-price contract to construct a large building. It is estimated that the building will take 2 years to complete. Progress billings will be sent to the customer at quarterly intervals. Which of the following describes the preferable point for revenue recognition for this contract if the outcome of the contract can be estimated reliably?

- A. After the contract is signed.
- B. As progress is made toward completion of the contract.
- C. As cash is received.
- D. When the contract is completed.

**Answer: B**

Under the percentage-of-completion method, revenues and expenses are recognize based on the stage of completion at the balance sheet date if the outcome of the contract can be estimated reliably. For a fixed-price contract, the outcome can be estimated reliably if1) total revenue can be measured reliably.2) it is probable that the economic benefits of the contract will flow to the enterprise.3) contract costs to complete and stage of completion can be measured reliably, and4) contract costs can be clearly identified and measured reliably so that actual and estimated costs can be compared.

**QUESTION: 40**

An airline should recognize revenue from airline tickets in the period when

- A. Passenger reservations are booked.
- B. B Passenger reservations are confirmed.
- C. Tickets are issued
- D. Related flights occur

**Answer: D**

Recognition of an element of financial statements (e.g., income, which includes revenue and gains) requires that two criteria be met. It must be probable that any future economic benefit associated with the item will flow to or from the enterprise, and the cost or value of the item must be measurable with reliability. The usual procedures for income recognition, e.g., that income be earned, reflect these criteria. Thus, income is recognized when an increase in future economic benefits is associated with an increase in an asset or a decrease in a liability. The recognition criteria are not met with respect to the collections from sales of airline tickets until the receipt of future economic benefits is sufficiently certain. Such certainty exists when the airline performs the contracted-for service, that is, when the related flights occur. The critical event in the earning process for the airline is the delivery of the service to the customer, which occurs when the related flight takes place.

**QUESTION: 41**

A company provides fertilization, insect control, and disease control services for a variety of trees, plants, and shrubs on contract basis. For US \$50 per month, the company will visit the subscriber's premises and apply appropriate. If the subscriber has any problem between the regularly scheduled application dates, the company's personnel will promptly make additional service calls to correct the situation. Some subscribers elect to pay for an entire year because the company offers an annual price of 115 \$540 if paid in advance. For a subscriber who pays the annual fee in advance, the company should recognize the related revenue.

- A When the cash is collected.
- B. Evenly over the year as the services are performed.
- C. At the end of the contract year after all of the services have been performed.
- D At the end of the fiscal year.

**Answer: B**

Income, which includes revenue and gains, should not be recognized until an increase in future economic benefits related to an increase in an asset or a decrease in a liability is sufficiently certain and can be measured reliably. The most common time at which these two conditions are met is when the product or merchandise is delivered (services are rendered to customers). In the situation presented the performance of the service (monthly spraying) is so significant to creating a sufficient certainty of an increase in future economic benefits that revenue should not be recognized until delivery occurs.

**QUESTION: 42**

A company uses the percentage-of-completion method and reports the following:

	Year 1	Year 2
Construction costs	US \$100	US \$200
Estimated cost to complete at year-end	300	0

The contract price is US \$1,000. What is the profit recognized in Year 2?

- A. US \$150
- B US \$400
- C. US \$550
- D. US \$800

**Answer: C**

At the end of Year 1, total cost was expected to be US \$400 (\$100 incurred + \$300 estimated cost to complete), and estimated total profit was US \$600 (\$1,000 price – \$400 estimated total cost). Hence, the amount of profit recognized in Year 1 was US \$150 [(\$600 e\$100 incurred – \$400 estimated total cost)]. The project was completed in Year 2 at an additional cost of US \$200. Actual profit was therefore US \$700 – (\$1,000 – \$300 actual total cost). Profit recognized in Year 2 is US \$550: (\$700 total - \$150 recognized in Year 1).

**QUESTION: 43**

DEF is the consignee for 1,000 units of product X for ABC Company. ABC should recognize the revenue from these 1,000 units when

- A The agreement between DEF and ABC is signed.
- B. ABC ships the goods to DEF.
- C DEF receives the goods from ABC.
- D DEF sells the goods and informs ABC of the sale

**Answer: D**

Under a consignment arrangement, the consignor ships merchandise to the consignee who acts as agent for the consignor in selling the goods. The goods are in the physical possession of the consignee but remain the property of the consignor and are included in the consignor's inventory. Revenue and the related cost of goods sold from these consigned goods should only be recognized by the consignor when the merchandise is sold and delivered to the final customer. Accordingly, recognition occurs when notification is received that the consignee has sold the goods. Only then are the recognition criteria for a sale of goods satisfied: the enterprise has transferred the significant risks and reward of ownership, the enterprise has neither continuing managerial involvement to an extent associated with ownership nor effective control over the goods, the amount can be reliably measured, it is probable that the economic benefits will flow to the enterprise, and transactional costs can be reliably measured.



**QUESTION: 44**

A department store sells gift certificates that may be redeemed for merchandise. Each certificate expires 3 years after issuance. The revenue from the gift certificates should be recognized

- A. Evenly over 3 years from the date of issuance.
- B. In the period the certificates are sold.
- C. In the period the certificates expire.
- D. In the period the certificates are redeemed or in the period they expire if they are allowed to lapse.

**Answer: D**

Income, which includes revenue and gains, should not be recognized until an increase future economic benefits related to an increase in an asset or a decrease in a liability is sufficiently certain and can be measured reliably. These criteria are met when the certificates are redeemed or expire because the liability for redemptions will then decrease and economic benefits will be reliably measurable. On January 1, Year 1, a construction company signed a contract with a property management firm involving the construction of a large urban office tower. The total price of constructing the tower was agreed to be US \$10 million with US \$2 million being paid on the date of the agreement. Construction began immediately upon the signing of the contract and was expected to take 3 years to complete. The original estimate of total construction costs was US \$8 million. During the year ended December 31, Year 1, US \$4 million of construction costs were incurred, and engineering estimates indicated that the office tower was 30% complete at year-end. At year-end, the revised estimate of total construction costs was US \$8.5 million and the property management firm had been billed a further US \$4 million, although only US \$1 million of that amount had been collected by year-end.

**QUESTION: 45**

If the construction company uses the percentage-of-completion [cost-to-cost basis] method of revenue recognition, in Year 1 the amount of revenue it will recognize on the long-term contract will be

- A. US \$3,000,000
- B. US \$4,705,882
- C. US \$5,000,000
- D. US \$6,000,000

**Answer: B**

Under the cost-to-cost approach to determining the stage of completion of the contract, the stage of completion equals contract costs incurred to date divided by the most recent

estimate of total contract costs. Hence, the revenue to be recognized in the first year is US \$4,705,882 [ $\$10,000,000 - \$4,000,000 - \$8,500,000 \times 20\%$ ]. amount equals costs incurred plus recognized profit. On January 1, Year 1, a construction company signed a contract with a property management firm involving the construction of a large urban office tower. The total price of constructing the tower was agreed to be US \$10 million with US \$2 million being paid on the date of the agreement. Construction began immediately upon the signing of the contract and was expected to take 3 years to complete. The original estimate of total construction costs was US \$8 million. During the year ended December 31, Year 1, US \$4 million of construction costs were incurred, and engineering estimates indicated that the office tower was 30% complete at year-end. At year-end, the revised estimate of total construction costs was US \$9 million and the property management firm had been billed a further US \$4 million, although only US \$1 million of that amount had been collected by year-end.

**QUESTION: 46**

Assume that the construction company recognizes US \$2 million of revenue for the long-term contract in Year 1. If the company uses the percentage-of-completion method (cost-to-cost basis), the difference between revenue recognized to date and contract billings at the end of Year 1 will be shown on the December 31, Year 1, balance sheet as a <List A> of <List B>.

	List A	List B
A.	Current asset	US \$1,000,000
B.	Current asset	US \$4,000,000
C.	Current liability	US \$1,000,000
D.	Current liability	US \$4,000,000

**Answer: D**

the gross amount due from/to customers for contract work is an asset/liability). If the amount of costs incurred plus recognized profits minus recognized loss exceeds progress billings, the entity reports an asset. If the amount of progress billings exceeds costs incurred plus recognized profits minus recognized losses, the entity reports a liability. At the end of Year 1, the company had recognized US \$2,000,000 of revenue (costs to date + recognized profit) and had submitted billings of US \$6,000,000. Thus, the excess billings equal US \$4,000,000. Because the billings exceed revenue recognized, this amount is listed as a current liability. It represents deferred revenue. Given a US \$10 million fixed price and US \$8.5 million of total costs, the assumption that US \$2 million of revenue was recognized under the percentage-of-completion method (cost-to-cost basis) necessarily includes the assumption that the stage of completion was 20% ( $\$2 \text{ million} / \$10 \text{ million}$ ), that recognized profit was US \$300,000 [ $(\$10 \text{ million} - \$8.5 \text{ million}) \times 20\%$ ], and that costs to date were US \$1.7 million ( $\$8.5 \text{ million} \times 20\%$ ). On January 1, a new landscaping firm, Bandit Co., acquired a fleet of vehicles, all the necessary tools and equipment, and a parking and storage facility. It began operations immediately. It is now the end of the first year of operations, and the first set of year-end financial statements are being prepared. Several decisions have to be made regarding the appropriate accounting and reporting

practices for this company. Relevant information for several of these items is described in the following list of transactions and events:

At year-end, the parking and storage facility that was purchased for US \$150,000 has a fair value of US \$250,000. The physical flow of inventory is first in, first out, and the cost of materials has risen steadily over the year. To promote sales for the coming year, maintenance contracts were sold in December at very reasonable prices, provided that the customers paid cash. On April 1, the company arranged a US \$100,000 10% bank loan. Interest payments of US \$5,000 are due on October 1 and April 1 of each year during the 5-year term of the loan. During the first year of operations, the company experienced a 5% bad debt rate on credit sales. None of the bad debts are expected to be recovered, given that 5% is the industry average level of bad debts. Total credit sales for the year were US \$400,000. The year-end balance of accounts receivable includes uncollected overdue accounts of US \$100,000. Half of the uncollected overdue amounts are estimated to be uncollectible.

**QUESTION: 47**

Bandit Co. will recognize revenue from the December sale of the maintenance contracts in the List A, year if it selects List B basis reporting.

	List A	List B
A.	First	Cash
B.	First	Accrual
C.	Second	Cash
D.	Third	Accrual

**Answer: A**

Under the cash basis of accounting, revenue is recognized when the cash is received. Because the customers paid cash for the maintenance contracts in the first year, that is the year in which the revenue should be recognized. On January 1, a new landscaping firm, Bandit Co., acquired a fleet of vehicles, all the necessary tools and equipment, and a parking and storage facility. It began operations immediately. It is now the end of the first year of operations, and the first set of year-end financial statements are being prepared. Several decisions have to be made regarding the appropriate accounting and reporting practices for this company. Relevant information for several of these items is described in the following list of transactions and events:

At year-end, the parking and storage facility that was purchased for US \$150,000 has a fair value of US \$250,000. The physical flow of inventory is first in, first out, and the cost of materials has risen steadily over the year. To promote sales for the coming year, maintenance contracts were sold in December at very reasonable prices, provided that the customers paid cash. On April 1, the company arranged a US \$100,000 10% bank loan. Interest payments of US \$5,000 are due on October 1 and April 1 of each year during the 5-year term of the loan. During the first year of operations, the company experienced a 5% bad debt rate on credit sales. None of the bad debts are expected to be recovered, given that 5% is the industry average level of bad debts. Total credit sales for the year were US \$400,000. The year-end balance of accounts receivable includes uncollected overdue accounts of US \$100,000. Half of the uncollected overdue amounts are estimated

to be uncollectible.

**QUESTION: 48**

Bandit Co. will report a value of ,List A, for the parking and storage facility if it prepares financial reports consistent with the ,List B, principle.

	List A	List B
A.	US \$150,000	Matching
B.	US \$150,000	Historical cost
C.	US \$250,000	Going concern
D.	US \$250,000	Revenue recognition

**Answer: B**

An asset classified under property, plant, and equipment is measured initially at cost. This amount includes the purchase price and any directly attributable costs of bringing the asset to working condition for its intended use. Directly attributable costs include costs of, for example, site preparation, initial delivery and handling, installation, professional fees (e.g., those of architects and engineers), and dismantling and removing the asset and restoring the site. The purchase price is determined by adding any import fees and nonrefundable purchase taxes and subtracting any trade discounts and rebates.

**QUESTION: 49**

A company began work on a long-term construction contract in Year 1. The contract price was US \$3,000,000. Year-end information related to the contract is as follows

	Year 1	Year 2	Year 3
Estimated total cost	US \$2,000,000	US \$2,000,000	US \$2,000,000
Cost incurred	700,000	900,000	400,000
Billings	800,000	1,200,000	1,000,000
Collections	600,000	1,200,000	1,200,000

If the company uses the percentage-of-completion method of accounting for this contract, the profit to be recognized in Year 1 is

- A. US \$(100,000)
- B. US \$(100,000)
- C. US \$(200,000)
- D. US \$(350,000)

**Answer: D**

When the outcome of a contract can be reasonably estimated, the percentage-of-completion method for estimated recognizes revenue based on the stage of completion of the contract. One typical method for estimating the stage of completion is the

calculation of ratio of the contract costs incurred to date to the estimated total cost. The percentage-of-completion at year-end on the cost-to-cost basis is 35% US \$7150,1509. The profit for Year 1 is the anticipated profit on the contract times the completion percentage. Thus, profit for Year 1 is US \$350,000  $[(\$3,000,000 - \$2,000,000) \times 35\%]$ .

**QUESTION: 50**

A vendor sells specialty inks on consignment to a manufacturer of colored paper at a price of US \$200 per barrel. Payment is made to the vendor in the month the manufacturer uses the barrels in production. The vendor records revenues when the barrels are shipped and makes no adjusting entries to record unearned revenues until the December 31 closing of the books. At the end of July, the manufacturer had 40 barrels of ink on consignment. During August, the vendor consigned 50 barrels and received payment for 30 barrels. Another five barrels were returned to the vendor by the manufacturer for credit. At the end of August, what is the amount of unearned revenue contained in the vendor's accounts receivable from the manufacturer?

- A US \$3,000
- B. US \$4,000
- C. US \$11,000
- D. US \$12,000

**Answer: C**

Under a consignment arrangement, the consignor ships merchandise to the consignee who acts as agent for the consignor in selling the goods. The goods are in the physical possession of the consignee but remain the property of the consignor and are included in the consignor's inventory. Revenue and the related cost of goods sold from these consigned goods should only be recognized by the consignor when the merchandise is sold and delivered to the final customer. Accordingly, recognition occurs when notification is received that the consignee has sold the goods. Only then are the recognition criteria for a sale of goods satisfied: The enterprise has transferred the significant risks and rewards of ownership, the enterprise has neither continuing managerial involvement to an extent associated with ownership nor effective control over the goods, the amount can be reliably measured, it is probable that the economic benefits will flow to the enterprise, and transactional costs can be reliably measured. In this consignment arrangement, 30 barrels have been paid for, so the revenue is recognized for these barrels. The five barrels returned are not included in unearned revenue because they constitute a return of consigned goods. Accordingly, the amount of inappropriately recognized revenue is US \$11,000  $[(40 \text{ consigned} + 50 \text{ consigned} - 30 \text{ paid for} - 5 \text{ returns}) \times \$200]$ .

**QUESTION: 51**

An entity that sprays chemicals in residences to eliminate or prevent infestation of insects

requires that customers prepay for 3 months' service at the beginning of each new quarter. Select the term that appropriately describes this situation from the viewpoint of the entity.

- A. Deferred income.
- B. Earned income.
- C. Accrued income\_
- D. Prepaid expense.

**Answer:** A

The prepayment does not meet the income recognition criteria the future inflow of economic benefits is not sufficiently certain given that the entity has not done what is required to be entitled to those benefits. Thus, the amount received in advance is considered a liability (deferred income) because it represents an obligation to perform a service in the future (an outflow of economic benefits) arising from a past transaction.

**QUESTION:** 52

A manufacturer receives an advance payment for special-order goods that are to be manufactured and delivered within the next year. The advance payment should be reported in the manufacturer's current-year balance sheet as a(n)

- A. Current liability
- B. Noncurrent liability
- C. Contra asset amount.
- D. Accrued revenue.

**Answer:** A

Recognition of an element of financial statement (e.g., income which includes revenue and gains) requires that two criteria be met. It must be probable that any future economic benefit associated with the item will flow to or from the enterprise, and the cost or value of the item must be measurable with reliability. The usual procedures for income recognition, e.g., that income be earned, reflect these criteria. Thus, income is recognized when an increase in future economic benefits is associated with an increase in an asset or a decrease in a liability. However, the enterprise has not substantially completed what it must do to be entitled to the benefits represented by the advance payment, and the receipt of future economic benefits is not sufficiently certain to merit income recognition. Accordingly, a liability should be recognized because the entity has a current obligation arising from a past event that will require an outflow of economic benefits, that is, to deliver goods or to refund the customer's money. The delivery of good is to take place within a year of the balance-sheet date, therefore, the obligations is expected to be settled in the normal course of the operating cycle or is due to be settled within 12 months.

**QUESTION: 53**

An entity that owns a new professional basketball team sells season tickets to its team's games. The season lasts from November through April, with 10 games played each month. In Year 1, The entity collected US \$3 million from season-ticket sales for the Year 1 - Year 2 season. Its fiscal year-end is December 31. Based on this information, The enterprise should

- A Report a liability for unearned income of US \$2 million on its December 31, Year 1, balance sheet.
- B Report a liability for unearned income of US \$3 million on its December 31, Year 1, balance sheet.
- C Report income of US \$3 million on its Year 1 income statement.
- D. Report income of US \$1 million on its Year 2 income statement.

**Answer: A**

The collections represent a liability (deferred income). The income recognition criteria are not met with respect to the season ticket collections until the receipt of future economic benefits is sufficiently certain. Such certainty exists with respect to collections related to the games played as of the balance sheet date. Accordingly, the entity should recognize US \$1 million as income in Year 1 [(US \$3,000,000 - 6 months) x 2 months]. The remaining US \$2 million should be reported as a liability.

**QUESTION: 54**

The practice of recording advanced payments from customers as liabilities is an application of the

- A. Going concern assumption.
- B. Monetary unit assumption.
- C. Historic cost principle.
- D. Revenue recognition principle.

**Answer: D**

Since the amount received in cash has not yet been earned, it is appropriate to record the advance payment as a liability of the company. This is an example of the revenue recognition principle, which states that revenue should not be recognized until it is earned.

**QUESTION: 55**

A transfer of receivables, with recourse, in exchange for cash should

- A. Not be recorded until all of the receivables have been collected.
- B. Be recorded as a sale or a borrowing transaction, depending on the provisions of the transfer agreement.
- C. Be recorded as a sale of receivables.
- D. Be recorded as a borrowing transaction.

**Answer: B**

An entity derecognizes a financial asset or a part thereof when it loses control of the contractual rights the asset represents. Control is lost when the entity realizes the rights to the benefits of the contract, the rights expire, or the entity surrenders the rights. Moreover, whether loss of control has occurred depends on the positions of both the transferor and the transferee. Control is not lost, for example, if the entity may reacquire the asset unless it is readily obtainable in the market or the price is fair value) or when the transferor is entitled and obligated to repurchase or redeem at a price giving the transferee a lender's return. Control ordinarily is lost when the transferee may obtain the benefits of the asset, for example, if the transferee may freely sell or pledge the full fair value of the asset. When the conditions above are met, the transfer of receivables with recourse is accounted for as a sale, with the proceeds of the sale reduced by the fair value of the recourse obligation (a new financial liability).

**QUESTION: 56**

An entity has appropriately used the installment method of accounting. It began operations at the beginning of the current year. The following information pertains to its operations for this year:

Installment sales	US \$1,200,000
Cost of installment sales	840,000
Collections on installment sales	480,000
General and administrative expenses	120,000

The amount of gross profit deferred at the end of the current year should be

- A. US \$720,000
- B. US \$288,000
- C. US \$216,000
- D. US \$144,000

**Answer: C**

The gross profit on installment sales in US \$360,000 (\$1,200,000 installment sales - \$840,000 cost of installment sales). Accordingly, the gross profit percentage is 30% US \$360,000 gross profit ÷ \$1,200,000 installment sales), and the amount of gross profit



deferred at the end of the current year is 1.11: r. \$216.000 [(\$1 .200.000 installment sales – 480,000 collections x 30%]. General and administrative expense have no effect on the computation of realized gross profit or deferred gross profit. They are to be classified as operating expenses on the income statement in the period in which they are incurred.

**QUESTION: 57**

The major distinction between the function-of-expense format for the income statement and the "condensed" format recognized under U.S. GAAP is the separation of

- A. Operating and nonoperating data.
- B Income tax expense and administrative expenses.
- C Cost of goods sold expense and administrative expenses.
- D The effect on income taxes of extraordinary items and the effect on income taxes of profit or loss from ordinary activities.

**Answer: A**

IRS 1 does not require a particular income statement format, although, at a minimum, certain line items must be presented. The nature-of-expense format for the income statement provides one grouping for income items and one for expense items, similar to the "single-step" format recognized under U.S. GAAP. The function-of-expense format, on the other hand, resembles the U.S. GRAP "condensed" format except in one crucial respect: Under U.S. GAAP, other income and expenses must be reported in a separate section after income from operations.

**QUESTION: 58**

At January 1, Year 1, a sole proprietorship's assets totaled U`? \$710,900, and its liabilities amounted to US \$120,000\_ During Year 1, owner investments amounted to US \$72,000, and owner withdrawals totaled US \$75,000. At December 31, Year 1, assets totaled US \$270,000 and liabilities amounted to US \$171,000. The amount of profit for Year 1 was

- A US \$0
- B US \$6,000
- C US \$9,000
- D. US \$12,000

**Answer: D**

Profit or loss may be d +ivy )1 using the basis a canting equationassets = liabilities + equity). Equity at 1/1/Yr 1 was US \$90,000\$210,000 of liabilities). Equity at 12/31/Yr 1 was US \$99,000\$270,000 – \$171,000). Because owner transactions decreased assets by

US \$3,000\$72,000 Investment- \$75,000 withdrawals), profit must have been US \$12,000 [\$99,000 -\$90,000 - \$3,000)].

**QUESTION: 59**

An entity has a 50% gross margin, general and administrative expenses of US \$50, interest expense of US \$20, and profit of US \$10 for the year just ended\_ If the corporate tax rate is 50%, the level of sales for the year just ended was

- A. US \$90
- B. US \$135
- C US \$150
- D US \$180

**Answer: D**

Profit equals sales minus cost of sales, GSA expenses, interest, and tax. Given a 50% tax rate, profit before tax must have been US \$20 [\$10 profit - 1\_0 - 5 tax rate)]. Accordingly, profit before interest and tax must have been US \$40\$20 profit before tax + \$20 interest), and the gross marginsales - cost of sales) must have been US \$90\$40 profit before interest and tax + \$50 G&A expenses). If the gross margin is 50% of sales, sales equals US \$180\$90 gross margin - .5).

**QUESTION: 60**

Which combination below explains the impact of credit card interest incurred and paid during the period on1) equity on the balance sheet and2) the statement of cash flows?

	(1) Effect on Equity on Balance Sheet	(2) Reflected on Statement of Cash Flows as a(n)
A.	Decrease	Investing outflow
B.	Decrease	Operating or financing outflow
C.	No effect	Financing or investing outflow
D.	No effect	Operating outflow

**Answer: B**

Interest incurred is classified as interest expense on the income statement, which in turn reduces equity on the balance sheet by reducing retained earnings. Cash payments for interest made by an entity that is not a financial institution may be classified on the statement of cash flows as an outflow of cash from operating or financing activities.

**QUESTION: 61**

A reader of a statement of cash flows wishes to analyze the major classes of gross cash

receipts and gross cash payments from operating activities. Which methods of reporting cash flows from operating activities will supply that information?

- A. Both the direct and indirect methods\_
- B. Only the direct method.
- C. Only the indirect method.
- D Neither method

**Answer: B**

The statement of cash flows may report cash flows from operating activities in either an indirect or a direct format. The direct format reports the major classes of operating cash receipts and cash payments as gross amounts. The indirect presentation adjusts profit or loss to the same amount of net cash from operating activities that would be determined in accordance with the direct method. To arrive at this amount, the indirect method adjusts profit or loss for the effects of noncash transactions, deferrals or accruals of past or future operating cash flows, and income or expense related to financing or investing activities.

**QUESTION: 62**

In the statement of cash flows, the payment of cash dividends appears in the <List A> activities section as a <List B> of cash.

	List A	List B
A.	Operating or investing	Source
B.	Operating or financing	Use
C.	Investing or financing	Use
D.	Investing	Source

**Answer: B**

Dividends paid may be treated as a cash outflow from financing activities because they are a cost of obtaining resources from owners. However, they may also be treated as operating items to help determine the entity's ability to pay dividends from operating cash flows.

**QUESTION: 63**

The comparative balance sheet for an enterprise that had profit of US \$150,000 for the year ended December 31, Year 2, and paid US \$125,000 of dividends during Year 2 is as follows:

	<u>12/31/Yr 2</u>	<u>12/31/Yr 1</u>
Cash	US \$150,000	US \$180,000
Accounts receivable	<u>200,000</u>	<u>220,000</u>
Total assets	<u>US \$350,000</u>	<u>US \$400,000</u>
Payables	US \$ 80,000	US \$160,000
Share capital	130,000	125,000
Retained earnings	<u>140,000</u>	<u>115,000</u>
Total	<u>US \$350,000</u>	<u>US \$400,000</u>

If dividends paid are treated as a cost of obtaining financial resources, the amount of net cash from operating activities during Year 2 was

- A. US \$70,000
- B. US \$90,000
- C. US \$150,000
- D. US \$210,000

**Answer: B**

Profit is adjusted to determine the net cash from operations. The payment of cash dividends is regarded as a cash flow from financing activity. Hence it is not a reconciling item. However, the decrease accounts receivable [US \$200,000 – \$200,000) = US \$20,000) during the period represents a cash flowcollections of pre-year 2 receivables) not reflected in Year 2 profit. Moreover the decrease in liabilities) that also is not reflected in Year 2 net income Accordingly, net cash from operations was US \$900,000\$150,000 + \$20,000 – \$80,000).

**QUESTION: 64**

A corporation reported salaries expense of US \$190,000 for December of the current year. The following data are from its records:

	<u>Dec. 31</u>	<u>Nov. 30</u>
Prepaid salaries	US \$ 46,000	US \$ 40,000
Salaries payable	<u>170,000</u>	<u>140,000</u>

The amount of cash payments for salaries during December of the current year was

- A. US \$154,000
- B. US \$166,000
- C. US \$214,000
- D. US \$226,000

**Answer: B**

An increase in prepaid salaries indicates that salaries expense is less than the cash paid for salaries. An increase in salaries payable indicates that salaries expense is more than

the cash paid for salaries. Thus, the amount of cash payments for salaries was US \$166.000 (\$190,000 salaries expense + \$6,000 increase in prepaid salaries - \$30,000 increase in salaries payable).

**QUESTION: 65**

In reconciling profit on an accrual basis to net cash from operating activities, what adjustment is needed to profit because of 1) an increase during the period in prepaid expenses and 2) the periodic amortization of premium on bonds payable?

	(1) Increase in Prepaid Expenses	(2) Amortization of Premium on Bonds Payable
A.	Add	Add
B.	Add	Deduct
C.	Deduct	Add
D.	Deduct	Deduct

- A. Add Add  
B. Add Deduct  
C. Deduct Add  
D. Deduct Deduct

**Answer: D**

An increase in prepaid expenses indicates that cash outlays for expenses exceeded the related expense incurred, thus, profit exceeded net cash from operating activities, and a deduction is needed in the reconciliation. Also, the amortization of premium on bonds payable causes a reduction of interest expense but does not increase cash; therefore, profit exceed net cash from operating activities, and a deduction is needed in the reconciliation. Balance sheets on December 31, Year 1, and December 31, Year 2, are presented below

	Dec. 31, Year 1	Dec. 31, Year 2	Liabilities and equity:		
Assets:			Trade accounts payable	US \$ 62,000	US \$ 49,000
Cash	US \$ 50,000	US \$ 60,000	Interest payable	8,000	11,000
Accounts receivable	95,000	89,000	Bonds payable	200,000	200,000
Allowance for uncollectible accounts	(4,000)	(3,000)	Unamortized bond discount	(15,000)	(10,000)
Inventory	120,000	140,000	Equity	199,000	257,000
Property, plant, and equipment	295,000	340,000	Total liabilities and equity	<u>US \$454,000</u>	<u>US \$507,000</u>
Accumulated depreciation	<u>(102,000)</u>	<u>(119,000)</u>	Additional information for Year 2:		
Total Assets	<u>US \$ 454,000</u>	<u>US \$ 507,000</u>	1. Cash payments to suppliers of merchandise were US \$180,000.		
			2. Sales revenue was US \$338,000.		
			3. US \$3,000 of accounts receivable was written off.		
			4. Equipment was acquired for US \$65,000.		
			5. Depreciation expense was US \$30,000.		
			6. Interest expense was US \$20,000.		

**QUESTION: 66**

Cost of goods sold in Year 2 was

- A. US \$147,000
- B. US \$160,000
- C. US \$167,000
- D. US \$180,000

**Answer: A**

Cost of goods sold equals beginning inventory, plus purchases, minus ending inventory. To determine cost of goods purchases must be calculated. Purchases equal US \$167,000 (\$49,000 ending accounts payable + \$130,000 payments to suppliers - \$62,000 beginning accounts payable). Thus, cost of goods sold equals US \$147,000 (\$120,000 beginning inventory + \$167,000 purchases - \$140,000 ending inventory).

Balance sheets on December 31, Year 1, and December 31, Year 2, are presented below

	Dec. 31, Year 1	Dec. 31, Year 2	Liabilities and equity:		
Assets:			Trade accounts payable	US \$ 62,000	US \$ 49,000
Cash	US \$ 50,000	US \$ 60,000	Interest payable	8,000	11,000
Accounts receivable	95,000	89,000	Bonds payable	200,000	200,000
Allowance for uncollectible accounts	(4,000)	(3,000)	Unamortized bond discount	(15,000)	(10,000)
Inventory	120,000	140,000	Equity	199,000	257,000
Property, plant, and equipment	295,000	340,000	Total liabilities and equity	<u>US \$454,000</u>	<u>US \$507,000</u>
Accumulated depreciation	(102,000)	(119,000)	Additional information for Year 2:		
Total Assets	<u>US \$ 454,000</u>	<u>US \$ 507,000</u>	1. Cash payments to suppliers of merchandise were US \$180,000.		
			2. Sales revenue was US \$338,000.		
			3. US \$3,000 of accounts receivable was written off.		
			4. Equipment was acquired for US \$65,000.		
			5. Depreciation expense was US \$30,000.		
			6. Interest expense was US \$20,000.		

**QUESTION: 67**

Cash collections from customers in Year 2 were

- A. US \$341,000
- B. US \$338,000
- C. US \$344,000
- D. US \$335,000

**Answer: A**

Cash collections from customers equals beginning accounts receivable, plus sales revenue, minus accounts written off, minus ending accounts receivable. In Year 2, cash collections from customers were US \$341,000 (\$95,000 + \$338,000 - \$3,000 - \$89,000). Balance sheets on December 31, Year 1, and December 31, Year 2, are presented below

	Dec. 31, Year 1	Dec. 31, Year 2			
Assets:			Liabilities and equity:		
Cash	US \$ 50,000	US \$ 60,000	Trade accounts payable	US \$ 62,000	US \$ 49,000
Accounts receivable	95,000	89,000	Interest payable	8,000	11,000
Allowance for uncollectible accounts	(4,000)	(3,000)	Bonds payable	200,000	200,000
Inventory	120,000	140,000	Unamortized bond discount	(15,000)	(10,000)
Property, plant, and equipment	295,000	340,000	Equity	199,000	257,000
Accumulated depreciation	(102,000)	(119,000)	Total liabilities and equity	<u>US \$454,000</u>	<u>US \$507,000</u>
Total Assets	<u>US \$ 454,000</u>	<u>US \$ 507,000</u>			
			Additional information for Year 2:		
			1. Cash payments to suppliers of merchandise were US \$180,000.		
			2. Sales revenue was US \$338,000.		
			3. US \$3,000 of accounts receivable was written off.		
			4. Equipment was acquired for US \$65,000.		
			5. Depreciation expense was US \$30,000.		
			6. Interest expense was US \$20,000.		

**QUESTION: 68**

The carrying amount (cost minus accumulated depreciation) of property, plant, and equipment disposed of in Year 2 was

- A. US \$7,000
- B. US \$17,000
- C. US \$20,000
- D. US \$32,000

**Answer: A**

The cost of PPE disposed of is US \$20,000 (\$295,000 beginning PPE + 65,000 acquisitions - \$340,000 ending PPE). The accumulated depreciation + \$30,000 depreciation expense - \$119,000 ending accumulated depreciation. Thus, the carrying amount of PPE disposed of is US \$7,000. I I Or II i depreciation).

Balance sheets on December 31, Year 1, and December 31, Year 2, are presented below

	Dec. 31, Year 1	Dec. 31, Year 2	Liabilities and equity:		
Assets:			Trade accounts payable	US \$ 62,000	US \$ 49,000
Cash	US \$ 50,000	US \$ 60,000	Interest payable	8,000	11,000
Accounts receivable	95,000	89,000	Bonds payable	200,000	200,000
Allowance for uncollectible accounts	(4,000)	(3,000)	Unamortized bond discount	(15,000)	(10,000)
Inventory	120,000	140,000	Equity	199,000	257,000
Property, plant, and equipment	295,000	340,000	Total liabilities and equity	US \$454,000	US \$507,000
Accumulated depreciation	(102,000)	(119,000)			
Total Assets	US \$ 454,000	US \$ 507,000	Additional information for Year 2:		

1. Cash payments to suppliers of merchandise were US \$180,000.
2. Sales revenue was US \$338,000.
3. US \$3,000 of accounts receivable was written off.
4. Equipment was acquired for US \$65,000.
5. Depreciation expense was US \$30,000.
6. Interest expense was US \$20,000.

**QUESTION: 69**

Cash interest payments in Year 2 were

- A. US \$8,000
- B. US \$12,000
- C. US \$20,000
- D. US \$25,000

**Answer: B**

The interest payable credited in Year 1 was US \$15,000 (\$20,000 interest expense - \$5,000 amortized bond discount). Thus, the cash interest payment was US \$12,000 (\$8,000 beginning interest payable + \$15,000 interest payable credited in Year 1 - \$11,000 ending interest payable).

**QUESTION: 70**

In the determination of cost of goods sold, <List A> must be <List B> cash payments for goods along with other adjustments.

	List A	List B
A.	An increase in accounts payable	Added to
B.	A decrease in accounts payable	Added to
C.	An increase in inventory	Added to
D.	A decrease in inventory	Subtracted from

**Answer: A**

To convert from the cash basis (cash payments) to the accrual basis (cost of goods sold), an accounts payable must be added to cash payments for goods to determine net purchases. Net purchases is then adjusted for the change in inventory to determine cost of goods



sold.

**QUESTION: 71**

An entity has publicly announced a detailed, formal plan to dispose in its entirety of a component of the entity that represents a separate major line of business that is distinct operationally and financially. Which of the following is the proper treatment of the disclosures that should be made after the announcement?

- A. As part of continuing operations.
- B. As a discontinued operation.
- C. As an extraordinary item.
- D. As a prior-period item.

**Answer: B**

A separate major line of business or geographical operating area that is distinct for operational and reporting purposes is a component of an entity. Thus, its disposal qualifies to be reported.

**QUESTION: 72**

Which of the following is a unique reporting problem associated with the determination of the results of operations for an interim period?

- A. Advertising and similar costs expensed in one interim period may benefit other interim periods in the same annual period.
- B. Cost of goods sold for an interim period reflects only the amount of product cost applicable to sales revenue recognized in the interim period.
- C. Depreciation for an interim period represents an estimate.
- D. An extraordinary loss occurring in the second quarter must be prorated over the last three interim periods of the year.

**Answer: A**

Costs and expenses other than product costs should be either charged to income in interim periods as incurred or allocated among interim periods based upon the benefits received. Accordingly costs such as advertising should be deferred in an interim period if the benefits extend beyond that period; otherwise, they should be expensed as incurred. But such a determination is difficult, and deferral raises the additional issue of how the deferred costs should be allocated among quarters. Thus, many entities expense the costs as incurred even though they may benefit other interim periods in the same annual period.

**QUESTION: 73**

The following data were extracted from the financial statements of a company for the year ended December 31.

Profit	US \$70,000
Depreciation expense	14,000
Amortization of intangibles	1,000
Decrease in accounts receivable	2,000
Increase in inventories	9,000
Increase in accounts payable	4,000
Increase in plant assets	47,000
Increase in share capital	31,000
Decrease in short-term notes payable	55,000

- A. US \$11,000
- B. US \$17,000
- C. US \$54,000
- D. US \$69,000

**Answer: A**

Depreciation and amortization are noncash expenses and are added to profit. A decrease in receivables indicates that cash collections exceed sales on an accrual basis, so it is added to profit. To account for the difference between cost of goods sold (a deduction from profit) and cash paid to suppliers, a two-step adjustment of profit is necessary. The difference between cost of goods sold and purchases is the change in inventory. The difference between purchases and the amount paid to suppliers is the change in accounts payable. Accordingly, the conversion of profit to cash paid to suppliers requires deducting the inventory increase and adding the accounts payable increase. An increase in plant assets indicates an acquisition of plant assets, causing a decrease in cash, so it is deducted. An increase in share capital represents a cash inflow and is added to profit. A decrease in short-term notes payable is deducted from profit because it reflects a cash outflow. Thus, cash increased by US \$11,000  $\{ \$70,000 \text{ profit} + \$14,000 + \$1,000 + \$2,000 - \$9,000 + \$4,000 - \$47,000 + \$31,000 - \$55,000 \}$ .

**QUESTION: 74**

A newly acquired plant asset is to be depreciated over its useful life. The rationale for this process is the

- A. Economic entity assumption.
- B. Monetary unit assumption.
- C. Materiality assumption.
- D. Going concern assumption.

**Answer: D**

A basic feature of financial accounting is that the entity is assumed to be a going concern in the absence of evidence to the contrary. The going concern concept is based on the empirical observation that many entities have an indefinite life. The reporting entity is

assumed to have a life long enough to fulfill its objectives and commitments and therefore to depreciate wasting assets over their useful lives.

**QUESTION: 75**

Assuming all of the following involve material amounts, which is most likely to be classified as an extraordinary item in the income statement?

- A. A loss because of an expropriation of assets by a foreign government.
- B. A loss because of adjustments of accruals on long-term contracts.
- C. A gain because of the disposal of assets associated with a discontinuing operation of a business.
- D. None of the above.

**Answer: D**

According to IAS 1, An entity shall not present any items of income and expense as extraordinary items, either on the face of the income statement or in the notes."

**QUESTION: 76**

An extraordinary gain occurs in the second fiscal quarter. How should the gain be accounted for?

- A. Recognized in full in the second quarter.
- B. Recognized equally over the second, third, and fourth quarters.
- C. Recognized only in the annual financial statements.
- D. Recognized equally in each quarter, by restating the first quarter.

**Answer: A**

Gains and losses similar to those that would not be deferred at year-end should not be deferred to later interim periods of the same year. Hence, the extraordinary gain should not be prorated. However, no items of income or expense are presented as extraordinary on the income statement or in the notes

**QUESTION: 77**

RLF Corporation had profit before taxes of US \$60,000 for the year. Included in this amount were depreciation of US \$5,000. a charge of US \$6,000 for the amortization of bond discounts, and US \$4,000 for interest expense. The estimated cash flow for the period is

- A. US \$60,000
- B. US \$66,000
- C. US \$49,000
- D. US \$71,000

**Answer: D**

To determine cash flow for the period, all noncash expenses should be added back to profit. Adding the US \$5,000 of depreciation and the US \$6,000 of discount amortization to the US \$60,000 of profit produces a cash flow of US \$71,000.

**QUESTION: 78**

The management of ABC Corporation is analyzing the financial statements of XYZ Corporation because ABC is strongly considering purchasing a block of XYZ ordinary shares that would give ABC significant influence over XYZ. Which financial statement should ABC primarily use to assess the amounts, timing, and certainty of future cash flows of XYZ Company?

- A. Income statement.
- B. Statement of changes in equity.
- C. Statement of cash flows.
- D. Balance sheet.

**Answer: C**

A statement of cash flows provides information about the cash receipts and cash payments of an enterprise during a period. This information helps investors, creditors, and other users to assess the enterprise's ability to generate cash and cash equivalents and the needs of the enterprise to use those cash flows. Historical cash flow data indicate the amount, timing, and certainty of future cash flows. It is also a means of verifying past cash flow assessments and of determining the relationship between profits and net cash flows and the effects of changing price.

**QUESTION: 79**

In a statement of cash flows (indirect method), depreciation expense should be presented as

- A. An inflow of cash.
- B. An outflow of cash.
- C. An addition to profit in converting profit or loss to net cash flows from operating activities.
- D. A deduction from profit in converting profit or loss to net cash flows from operating

activities.

**Answer: C**

Net cash flow from used by) operating activities may be reported indirectly by removing from profit or loss the effects of 1) deferrals of past operating cash flows, 2) accruals of expected future operating cash flows, 3) income or expense items related to financing and investing cash flows, and 4) noncash transactions. These adjustments include such items as depreciation, amortization of patents, amortization of bond discount and bond premium gains and losses, changes during the period in trade receivables, changes in inventory, and changes in accounts payable and accrued liabilities. In the reconciliation of profit or loss to net cash from used by) operations, depreciation (a noncash expense) is added to profit or loss.

**QUESTION: 80**

A financial statement includes all of the following items: profit, depreciation, operating activities, and financing activities. What financial statement is this?

- A. Balance sheet.
- B. Income statement.
- C. Statement of cash flows.
- D. Statement of changes in equity.

**Answer: C**

A statement of cash flows is a required financial statement. It provides information about cash receipts and payments by reporting the cash effects of an enterprise's operating, investing, and financing activities. Related disclosures report the effects of noncash investing and financing activities. If the statement is presented using the indirect method, it will reconcile profit or loss to net cash from used in) operating activities. Depreciation, a noncash expense, is included in this presentation.

**QUESTION: 81**

An enterprise decided to sell a separate major line of its business. The assets were sold for US \$100,000 and had a net carrying amount US \$70,000. The applicable tax rate was 20%. The result of this transaction may appear on the

- A. Balance sheet as a fundamental error.
- B. Income statement as an extraordinary item.
- C. Income statement as a single amount for a discontinued operation
- D. Income statement as a change in accounting policy

**Answer: C**

A discontinued operation (DO) is a component of an entity that has been disposed of or meets the criteria for classification as held for sale. It is 1) a separate major line of business or geographical operating area, 2) part of a single plan to dispose of such a line or area, or 3) a subsidiary acquired solely for resale. A component of an entity consists of operations and cash flows that are clearly distinguishable from the rest of the entity for financial reporting as well as operationally. A single amount is disclosed on the face of the income statement equal to the sum of 1) after-tax profit (loss) on DOs and 2) after-tax gain (loss) on a) remeasurement of noncurrent assets or disposal groups classified as held for sale at fair value minus cost to sell or b) disposal of the assets or disposal groups that constituted the DO.

**QUESTION: 82**

On December 1, Year 1, a company using the installment sales method sold goods that cost US \$1,000 for US \$1,500. The buyer paid US \$100 down. Monthly payments start January 1, Year 2. Interest accrues at 1% per month on the unpaid balance. To the nearest dollar, the effect on profit for Year 1 is

- A. US \$33 increase.
- B. US \$47 increase.
- C. US \$67 increase.
- D. US \$114 increase.

**Answer: B**

The gross profit margin is 33-1/3% [(US \$1,500 - \$1,000) / \$1,500], so the amount of profit from the US \$100 down payment recognizable in Year 1 is US \$33 (rounded). Interest accrued on the US \$1,400 (\$1,500 - \$100) balance for 1 month is US \$14. Consequently the effect on profit is US \$47 (\$33 + \$14).

**QUESTION: 83**

On January 31, Year 3, a company prepaid the US \$72,000 rental fee for a parking lot it leases. The rental fee covered a 3-year period beginning February 1, Year 3. What is the effect of this transaction on the December 31, Year 3, financial statements for each of the following?

	Current Expenses	Prepaid Expenses
A.	US \$0	US \$72,000
B.	US \$22,000	US \$50,000
C.	US \$24,000	US \$48,000
D.	US \$72,000	US \$0

**Answer: B**

The US \$72,000 rental fee should be recognized as expense evenly over the 36-month

duration of the lease. In Year 3, US \$22,000 should be deferred to current expenses [(US \$72,000 / 36 months) x 11 months], and US \$50,000 should be deferred as prepaid expense. On January 1, a new landscaping firm, Bandit Co., acquired a fleet of vehicles, all the necessary tools and equipment, and a parking and storage facility. It began operations immediately. It is now the end of the first year of operations, and the first set of year-end financial statements are being prepared. Decisions have to be made regarding the appropriate accounting and reporting practices for this company. Relevant information for several of these items is described in the following list of transactions and events:

At year-end the parking and storage facility that was purchased for US \$150,000 has a fair value of US \$250,000. The physical flow of inventory is first in, first out, and the cost of materials has risen steadily over the year. To promote sales for the coming year, maintenance contracts were sold in December at very reasonable prices, provided that the customers paid cash. On April 1, the company arranged a US \$100,000 10% bank loan. Interest payments of US \$5,000 are due on October 1 and April 1 of each year during the 5-year term of the loan. During the first year of operations, the company experienced a 5% bad debt rate on credit sales. None of the bad debts are expected to be recovered, given that 5% is the industry average level of bad debts. Total credit sales for the year were US \$400,000. The year-end balance of accounts receivable includes uncollected overdue accounts of US \$100,000. Half of the uncollected overdue amounts are estimated to be uncollectible.

**QUESTION: 84**

If Bandit Co. uses the <List A> approach to estimate bad debt expense, the estimated bad debt expense will be <List B>.

	List A	List B
A.	Balance sheet	US \$20,000
B.	Balance sheet	US \$100,000
C.	Income statement	US \$20,000
D.	Income statement	US \$50,000

**Answer: C**

Using the income statement approach, the bad debt expense is determined using a percentage of total credit sales. Thus, bad debt expense is US \$20,000 (\$400,000 credit sales x 5% estimated bad debt rate).

**QUESTION: 85**

A project is expected to result in the following adjustments over the next year:

- Cash sales increase by US \$400,000.
- Expenses (except depreciation) increase by US \$180,000
- Depreciation increases by US \$80,000.

Assume the corporate tax rate is 34%. The total relevant net cash flows during that year are

- A. US \$92,400
- B. US \$140,000
- C. US \$172,400
- D. US \$220,000

**Answer: C**

The increase in pre-tax profit is US \$140,000 (\$400,000 cash sales increase - \$180,000 nondepreciation expenses increase - \$80,000 depreciation). Thus, taxes will increase by US \$47,600 (\$140,000 x 34%), and the increase in net cash inflows will be US \$172,400 (\$400,000 - \$180,000 - \$47,600).

**QUESTION: 86**

A company had US \$30 million in total sales last year and expects US \$40 million in total sales this year. Ten percent of each year's sales are on credit that will be paid the following year. The company anticipates the following expenses for this year:

- Depreciation of US \$5 million.
- Labor, materials, taxes, and other expenses of US \$51 million.

Assume the company begins this year with a zero cash balance. At the end of this year, the company will have a cash deficit of

- A. US \$8 million.
- B. US \$12 million.
- C. US \$15 million.
- D. US \$17 million.

**Answer: B**

The cash inflows from last year's credit sales are estimated to be US \$3,000,000 (\$10,000,000 x 30%). The cash inflows from this year's sales are expected to be US \$36,000,000 (\$40,000,000 x 90%), a total cash inflow of US \$39,000,000 for the current year. Ignoring depreciation, which is a noncash expense, cash outflows are estimated at US \$51,000,000. Hence, the net cash outflow is anticipated to be US \$12,000,000 (\$39,000,000 - \$51,000,000).

**QUESTION: 87**

The management discussion and analysis section of a company's annual report typically contains

- A. A description of the company's primary business and segments.
- B. A discussion of the company's operating results.
- C. A discussion of the future prospects of the company.



D. All of the answers are correct.

**Answer: D**

The MD&A section addresses capital resources, liquidity, and operating results. Management must also identify trends and discuss significant events and uncertainties. Thus, the MD&A section typically includes a description of the company's primary business and segments. It reviews the operating results of the company, providing a breakdown of net sales and income by segment. It also contains prospective information on economic trends and market changes, and their potential effects on the company's future performance.

**QUESTION: 88**

IAS 34, interim Financial Reporting, provides guidelines for interim reporting stating that enterprises

- A. May use estimates based on sales margins for interim inventory valuation although a different method is used for annual reporting.
- B. Must determine income tax expense by applying progressive tax rates to income on a quarterly basis.
- C. May prorate extraordinary items over four quarters.
- D. Need not disclose basic and diluted earnings per share each quarter.

**Answer: A**

Essentially the same reporting methods should be used for interim and annual financial statements. However, the preparation of interim financial reports ordinarily requires a greater use of estimates. For example, IAS 34 states that complete inventory-taking and valuation may not be required at interim dates. Estimates based on sales margins may suffice. Copper Co. had the pre-closing trial balance at December 31 shown below. Additional information: The balance of opening inventory was US \$140,000. The long-term debt pays interest at a rate of 10% per annum, payable every 12 months. The debt was issued on July 1 of the current year and originally had 5 years to maturity. The assets classified as property, plant, and equipment have a 10-year estimated useful life and were 1 year old at the start of the current year. Straight-line depreciation is used.

Cash	US \$ 80,000
Accounts receivable	100,000
Inventory	230,000
Gross property, plant, and equipment	600,000
Accumulated depreciation	60,000
Accounts payable	200,000
Long-term debt	1,000,000
Share capital	2,000,000
Retained earnings (Jan. 1)	500,000
Sales revenue	750,000
Purchases	530,000
Administrative expenses	200,000

**QUESTION: 89**

The enterprise uses straight-line depreciation for financial reporting purposes, but uses accelerated depreciation for tax purposes. Which of the following account balances would be lower in the financial statements used for tax purposes than it would be in the general purpose financial statements?

- A. Accumulated depreciation.
- B. Cash.
- C. Retained earnings.
- D. Gross property, plant, and equipment.

**Answer: C**

Because the tax basis uses an accelerated method, depreciation expense and accumulated depreciation will be greater. Moreover, taxable income will be lower than financial net income. Consequently, tax-basis retained earnings will be less than that in the general purpose financial statements. Copper Co. had the pre-closing trial balance at December 31 shown below. Additional information: The balance of opening inventory was US \$140,000. The long-term debt pays interest at a rate of 10% per annum, payable every 12 months. The debt was issued on July 1 of the current year and originally had 5 years to maturity. The assets classified as property, plant, and equipment have a 10-year estimated useful life and were 1 year old at the start of the current year Straight-line depreciation is used.

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Inventory	230,000
Gross property, plant, and equipment	600,000
Accumulated depreciation	60,000
Accounts payable	200,000
Long-term debt	1,000,000
Share capital	2,000,000
Retained earnings (Jan. 1)	500,000
Sales revenue	750,000
Purchases	530,000
Administrative expenses	200,000

**QUESTION: 90**

Copper Co will report year-end total assets of

- A US \$800,000
- B US \$890,000
- C. US \$950,000
- D. US \$1,010,000

**Answer: B**

The year-end total assets can be determined by summing all of the assets and deducting accumulated depreciation (including the current year's depreciation). Total accumulated depreciation at the end of the second year is US \$120,000 [(\$600,000 - 10 years) x 2 years]. Total assets equal US \$890,000 (\$80,000 cash + \$100,000 A/R + \$230,000 EI + \$600,000 gross property, plant, and equipment - \$120,000 accumulated depreciation). Copper Co. had the pre-closing trial balance at December 31 shown below. Additional information: The balance of opening inventory was US \$140,000. The long-term debt pays interest at a rate of 10% per annum, payable every 12 months. The debt was issued on July 1 of the current year and originally had 5 years to maturity. The assets classified as property, plant, and equipment have a 10-year estimated useful life and were 1 year old at the start of the current year. Straight-line depreciation is used.

Cash	US \$ 80,000
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Inventory	230,000
Gross property, plant, and equipment	600,000
Accumulated depreciation	60,000
Accounts payable	200,000
Long-term debt	1,000,000
Share capital	2,000,000
Retained earnings (Jan. 1)	500,000
Sales revenue	750,000
Purchases	530,000
Administrative expenses	200,000

**QUESTION: 91**

Which adjusting entry should be used at year-end to account for interest expense on the long-term debt?

- A. Interest expense US \$100,000  
Interest payable US \$100,000
- B. Interest expense US \$50,000  
Cash US \$50,000
- C. Interest payable US \$100,000  
Interest expense US \$100,000
- D. Interest expense US \$50,000  
Interest payable US \$50,000

**Answer: D**

The debt was issued on July 1 and has been outstanding for only 6 months. Interest expense equals the face amount of the debt multiplied by the interest rate and the fraction

of the year the debt was outstanding  $[\text{US } \$1,000,000 \times 10\% \times 6 - 12] = \text{US } \$50,000$ . Because interest is payable on July 1, 6 months' interest is accrued and expensed in the current period. The payable is also recognized in the current period. Thus, the adjusting entry should be

Interest expense US \$50,000

Interest payable US \$50,000

Copper Co. had the pre-closing trial balance at December 31 shown below. Additional information: The balance of opening inventory was US \$140,000. The long-term debt pays interest at a rate of 10% per annum, payable every 12 months. The debt was issued on July 1 of the current year and originally had 5 years to maturity. The assets classified as property, plant, and equipment have a 10-year estimated useful life and were 1 year old at the start of the current year. Straight-line depreciation is used.

Cash	US \$ 80,000
Accounts receivable	100,000
Inventory	230,000
Gross property, plant, and equipment	600,000
Accumulated depreciation	60,000
Accounts payable	200,000
Long-term debt	1,000,000
Share capital	2,000,000
Retained earnings (Jan. 1)	500,000
Sales revenue	750,000
Purchases	530,000
Administrative expenses	200,000

### QUESTION: 92

Assume that the enterprise reports cost of goods sold of US \$200,000 and interest expense of US \$10,000 for the current period. Also assume a 50% tax rate on corporate earnings. The final closing entry required to ensure that current earnings are incorporated into year-end retained earnings is

- A. Income summary US \$140,000  
Retained earnings US \$140,000
- B. Retained earnings US \$280,000  
Income summary US \$280,000
- C. Income summary US \$240,000  
Retained earnings US \$240,000
- D. Retained earnings US \$240,000  
Income summary US \$240,000

### Answer: A

Current period pretax net income equals  $\text{US } \$280,000$   $[\text{US } \$750,000 \text{ sales} - \$200,000 \text{ CGS} - \$60,000 \text{ depreciation} - \$10,000 \text{ interest} - \$200,000 \text{ administrative expenses}]$ . Thus, after-tax net income credited to retained earnings equals  $\text{US } \$140,000 [(10 - .5) \times \$280,000]$ .

### QUESTION: 93

Actual and projected sales of an entity for September and October are as follows:

	<u>Cash Sales</u>	<u>Credit Sales</u>
September (actual)	US \$20,000	US \$50,000
October (projected)	30,000	55,000

All credit sales are collected in the month following the month in which the sale is made. The September 30 cash balance is US \$23,000. Cash disbursements in October are projected to be US \$94,000. To maintain a minimum cash balance of US \$15,000 on October 31, the entity will need to borrow

- A. US \$0
- B US \$6,000
- C US \$11,000
- D. US \$16,000

**Answer: B**

This entity will collect US \$80,000 (\$50,000 from September credit sales + \$30,000 from October cash sales) in October. To reach its targeted cash balance on October 31, it will have to borrow US \$6,000.

September 30 cash balance		US \$23,000
Collections	US \$80,000	
Disbursements	<u>(94,000)</u>	<u>(14,000)</u>
Ending balance		9,000
Necessary borrowing		<u>6,000</u>
Targeted ending balance		<u>US \$15,000</u>

**QUESTION: 94**

Whenever an entity must use net realizable value rather than cost to value an inventory item, the inventory account is reduced and the account "expense due to decline of inventory to net realizable value" is increased. The balance of this account is reflected as a separate item on the

- A. Balance sheet as a deduction from inventory.
- B. Income statement as an extraordinary loss.
- C. Income statement as a deduction from gross profit on sales.
- D. Income statement as an operating expense.

**Answer: C**

If a separate expense account is not used, the ending inventory will be reduced directly and the result will be an increase in cost of goods sold. No separate disclosure of the inventory write down will appear in the income statement. The effect is to hide the loss in cost of goods sold. If the separate expense account is used, it appears on the income statement as a deduction from gross profit (sales - cost of goods sold). One advantage is that cost of goods sold is not misstated. At the end of the accounting period, an entity has the partially completed financial statements shown as follows.

## Income Statement:

Sales	
Cost of goods sold	
Gross profit	
Administrative expense	US \$ 40,000
Depreciation expense	
Profit before interest and tax	
Interest expense	
Profit before tax	
Tax expense	
Profit	100,000

## Balance Sheet:

Current assets	
Other assets	300,000
Total assets	
Current liabilities	
Long-term debt	1,000,000
Equity	
Total liabilities and equity	

## Additional Information:

Gross profit percentage = 30%

Tax rate = 40%

Annual interest cost on long-term debt = 10%

Return on total assets = 3%

Fixed assets originally cost US \$500,000 and are being depreciated over 10 years on a straight-line basis.

Working capital = US \$2,000,000

**QUESTION: 95**

The entity had sales for the period of

- A. US \$891,667
- B. US \$1,100,000
- C. US \$1,188,890
- D. US \$1,466,667

**Answer: C**

Gross profit equals 30% of sales. Thus, dividing gross profit by 30% yields sales. Gross profit equals profit before interest and tax (PBIT) plus administrative expense (given as US \$40,000) and depreciation (US \$500,000 fixed assets ÷ 10 years = US \$50,000). Interest equals 10% of the long-term debt, or US \$100,000 × 10%). Profit before tax equals US \$166,667 [US \$100,000 profit ÷ (1.0 - 40% tax rate)]. Hence, PBIT must equal US \$266,667 [US \$166,667 + US \$100,000], and gross profit must be US \$356,667 [US \$266,667 PBIT + US \$40,000 administrative expense + US \$50,000 depreciation). Sales is therefore US \$1,188,890 [US \$356,667 gross profit ÷ 30% gross profit rate].

At the end of the accounting period, an entity has the partially completed financial statements shown as follows.

Income Statement:	
Sales	
Cost of goods sold	
Gross profit	
Administrative expense	US \$ 40,000
Depreciation expense	
Profit before interest and tax	
Interest expense	
Profit before tax	
Tax expense	
Profit	100,000
Balance Sheet:	
Current assets	
Other assets	300,000
Total assets	
Current liabilities	
Long-term debt	1,000,000
Equity	
Total liabilities and equity	
Additional Information:	
Gross profit percentage = 30%	
Tax rate = 40%	
Annual interest cost on long-term debt = 10%	
Return on total assets = 3%	
Fixed assets originally cost US \$500,000 and are being depreciated over 10 years on a straight-line basis.	
Working capital = US \$2,000,000	

**QUESTION: 96**

The entity has current assets of

- A. US \$1,000,000
- B. US \$3,033,333
- C US \$3,333,333
- D. US \$3,633,333

**Answer: B**

Return on total assets 3%) equals profit (US \$100,000) divided by total assets. Consequently, total assets equal US \$3,333,333 (\$100,000 ÷ 0.03). Current assets must therefore equal US \$3,033,333 (\$3,333,333 total assets - \$300,000 other assets).

**QUESTION: 97**

Lawson Ltd. has the opportunity to increase annual sales US \$100,000 by selling to a new, riskier group of customers. Based on sales, the uncollectible expense this increase to be 15%, and collection costs will be 5%. Manufacturing and selling expenses are 70% of sales, and the effective tax rate is 40%. If Lawson accepts this opportunity, the after-tax profit will increase by

- A. US \$4,000
- B. US \$6,000
- C. US \$10,000

D. US \$9,000

**Answer: B**

Manufacturing and selling costs exclusive of bad debts equal 70% of sales. Hence, the gross profit in the US \$100,000 increase in sales will be US \$30,000  $\$100,000 \times 30\%$ . Assuming US \$15,000 of bad debts and US \$5,000 of collection expense, the increase in pre-tax profit will be

An entity has the following statements:

	Year 2	Year 1
Sales	US \$1,500,000	US \$1,400,000
Cost of goods sold	800,000	750,000
Gross profit	700,000	650,000
Selling and administrative expense	62,000	60,000
Depreciation expense	50,000	50,000
Profits before interest and taxes	688,000	540,000
Interest expense	100,000	100,000
Profit before taxes	588,000	440,000
Income tax (50%)	294,000	220,000
Profit	294,000	220,000

Selected balance sheet items are as follows:

	Year 2 Year-end	Year 1 Year-end
Accounts receivable	US \$300,000	US \$200,000
Accounts payable	250,000	275,000

Assume a 365-day year in any calculations.

**QUESTION: 98**

In Year 2, the entity had cash provided by operations of

- A. US \$219,000
- B. US \$244,000
- C. US \$344,000
- D. US \$469,000

**Answer: A**

Cash provided by operations equals profit, plus depreciation, minus the increase in accounts receivable, minus the decrease in accounts payable. The cash provided is US \$219,000  $[\$294,000 + \$50,000 - \$300,000 - \$200,000 - \$275,000 + \$250,000]$ . An increase in receivables is a noncash component of profit. A decrease in accounts payable is added when adjusting cost of goods sold to reflect cash paid to suppliers. Thus, it is subtracted when adjusting profit to arrive at cash provided by operations.

An entity has the following statements:



	Year 2	Year 1
Sales	US \$1,500,000	US \$1,400,000
Cost of goods sold	800,000	750,000
Gross profit	700,000	650,000
Selling and administrative expense	62,000	60,000
Depreciation expense	50,000	50,000
Profits before interest and taxes	688,000	540,000
Interest expense	100,000	100,000
Profit before taxes	588,000	440,000
Income tax (50%)	294,000	220,000
Profit	294,000	220,000

Selected balance sheet items are as follows:

	Year 2 Year-end	Year 1 Year-end
Accounts receivable	US \$300,000	US \$200,000
Accounts payable	250,000	275,000

Assume a 365-day year in any calculations.

**QUESTION: 99**

Based on the Year 2 year-end balance of accounts receivable and the Year 2 income statement, the company had an average collection period for Year 2 of

- A. 49 days.
- B. 52 days
- C. 73 days.
- D. 78 days.

**Answer: C**

The average collection period for Year 2 is 73 days [US \$300,000 accounts receivable / (\$1,500,000 sales / 365 days)].

**QUESTION: 100**

An entity offers its customers credit terms of a 2% discount if paid within 10 days, or the full balance is due within 30 days (2/10, n/30). If some customers take advantage of the cash discount and others do not, which of the following accounts will appear on the income statement if the net method of recording receivables is employed?

Sales Discounts

Sales Discounts Forfeited

- A. Yes Yes
- B. Yes No
- C. No No
- D. No Yes

**Answer: D**

The gross method accounts for receivables at their face amount. If a discount is taken, a

sales discount is recorded and classified as an offset to sales in the income statement to yield net sales. The net method records receivables net of the applicable discount. If the payment is not received during the discount period, an interest revenue account, such as sales discounts forfeited, is credited at the end of the discount period or when the payment is received. Accordingly, the application of the net method requires a sales discount forfeited but not a sales discount account.

**QUESTION: 101**

Big Co. holds 18% of the outstanding voting common shares of Little Co. How will Big report unrealized holding gains and losses on these shares?

- A. The treatment varies depending on whether Big classifies the shares as trading securities or available-for-sale securities.
- B. As items of other comprehensive income.
- C. As components in the calculation of net income.
- D. As either items of other comprehensive income or components in the calculation of net income, depending on whether the shares have been held longer than one year.

**Answer: A**

Less than 20% ownership is presumed to result in little or no influence over the investee. Such investments are initially recorded at cost and subsequently measured using the fair value method. If the investor classifies the shares as trading securities, unrealized holding gains and losses are included in the calculation of profit or loss. If the investor classifies the shares as available-for-sale securities, unrealized holding gains and losses are treated as items of other comprehensive income.

**QUESTION: 102**

An internal auditor is deriving cash flow data based on an incomplete set of facts. Bad debt expense was US \$2,000. Additional data for this period follows:

Credit sales	US \$100,000
Gross accounts receivable -- beginning balance	5,000
Allowance for bad debts -- beginning balance	(500)
Accounts receivable written off	1,000
Increase in net accounts receivable (after subtraction of allowance for bad debts)	30,000

How much cash was collected this period on credit sales?

- A. US \$64,000
- B. US \$68,000
- C. US \$68,500

D. US \$70,000

**Answer: B**

The beginning balance of gross accounts receivable (A/R) was US \$5,000 (debit). Thus, net beginning A/R was US \$4,500 (\$5,000 - \$660 credit in the allowance for bad debts). The allowance was credited for the US \$2,000 bad debt expense. Accordingly, the ending allowance (credit) was US \$1,500 (\$500 - \$1,000 write-off - \$2,000). Consequently, a US \$30,000 increase net A/R. ending net A/R must have been US \$34,500 (\$4,500 beginning net A/R + \$30,000), with ending gross A/R of US \$36,000 (\$34,500 + \$1,500). Collections were therefore US \$68,000 (\$5,000 beginning gross A/R - \$1,000 write-off + \$100,000

Gross A/R			
US \$ 5,000	Beg. Bal.	US \$ 1,000	Write-off
100,000	Cr. Sales	68,000	Collections
US \$ 36,000	End. Bal.		

**QUESTION: 103**

An analysis of an entity's US \$150,000 accounts receivable at year-end resulted in a US \$5,000 ending balance for its allowance for uncollectible accounts and a bad debt expense of US \$2,000. During the past year, recoveries on bad debts previously written off were correctly recorded at US \$500. If the beginning balance in the allowance for uncollectible accounts was US \$4,700, what was the amount of accounts receivable written off as uncollectible during the year?

- A. US \$1,200
- B. US \$1,800
- C. US \$2,200
- D. US \$2,800

**Answer: C**

Under the allowance method, uncollectible accounts are written off by a debit to the allowance account and a credit to accounts receivable. The US \$500 bad debts is accounted for by a debit to accounts receivable and a credit to the allowance account. The US \$2,000 bad debt expense is also credited to the allowance account. The amount of accounts receivable written off as uncollectible is US \$2,200 [\$5,000 ending allowance - \$4,700 beginning allowance + \$500 recoveries + \$2,000 bad debt expense].

**QUESTION: 104**

At the end of September, a entity has outstanding accounts receivable of US \$350 on third-quarter credit sales, composed as follows.

Month	Credit Sales	Still Outstanding at the End of September
July	US \$600	US \$100
August	900	170
September	500	80

The percentage of receivables in the 31-to-50-day age group at the end of September is

- A. 22.86%
- B. 28.57%
- C. 48.57%
- D. 71.43%

**Answer: C**

Receivables from August sales still outstanding at the end of September are in the 31 to-60-day age group. This group represents 48.57% of total receivables [US \$170 - \$100 + \$170 + \$80)].

An entity sells goods on an installment basis. The table below includes information about the level of installment sales, the cost of the goods sold on installment, and the cash receipts on installment sales for Year 1 through Year 3. All cash receipt amounts shown are net of any interest charges.

	Year 1	Year 2	Year 3
Installment sales	US \$10,000	US \$5,000	US \$20,000
Cost of installment sales	6,000	4,000	10,000
Cash receipts on Year 1 sales	2,000	4,000	4,000
Cash receipts on Year 2 sales		1,000	2,000
Cash receipts on Year 3 sales			4,000

**QUESTION: 105**

The rate of gross profit on Year 2 installment sales is

- A. 20%
- B. 40%
- C. 50%
- D. 80%

**Answer: A**

The rate of gross profit on Year 2 installment sales is 20% [(US \$5,000 of Year 2 installment sales - \$4,000 cost of Year 2 installment sale=,) - \$5,000 of Year 2 installment sales].

An entity sells goods on an installment basis. The table below includes information about the level of installment sales, the cost of the goods sold on installment, and the cash receipts on installment sales for Year 1 through Year 3. All cash receipt amounts shown are net of any interest charges.

	Year 1	Year 2	Year 3
Installment sales	US \$10,000	US \$5,000	US \$20,000
Cost of installment sales	6,000	4,000	10,000
Cash receipts on Year 1 sales	2,000	4,000	4,000
Cash receipts on Year 2 sales		1,000	2,000
Cash receipts on Year 3 sales			4,000

**QUESTION: 106**

The amount of gross profit to be recognized in Year 1 on Year 1 installment sales is

- A. US \$800
- B US \$2,000
- C US \$3,200
- D US \$4,000

**Answer: A**

In Year 1, cash receipts were US \$2,000 from Year 1 installment sales. The gross profit realized is the gross profit on the portion of sales for which payment has been received. This amount equals the Year 1 gross profit percentage multiplied by the cash receipts, or US \$800  $\{[(\$10,000 - \$6,000) / \$10,000] \times \$2,000\}$ .

An entity sells goods on an installment basis. The table below includes information about the level of installment sales, the cost of the goods sold on installment, and the cash receipts on installment sales for Year 1 through Year 3. All cash receipt amounts shown are net of any interest charges.

	Year 1	Year 2	Year 3
Installment sales	US \$10,000	US \$5,000	US \$20,000
Cost of installment sales	6,000	4,000	10,000
Cash receipts on Year 1 sales	2,000	4,000	4,000
Cash receipts on Year 2 sales		1,000	2,000
Cash receipts on Year 3 sales			4,000

**QUESTION: 107**

The gross profit amount from Year 3 sales to be deferred to future years would be

- A. US \$2,000
- B. US \$3,000
- C. US \$8,000
- D. US \$10,000

**Answer: C**

The total gross profit on Year 3 sales is US \$10,000 (\$20,000 sales – \$10,000 cost), and the amount realized is US \$2,000  $\{[(\$20,000 - \$10,000) / \$20,000] \times \$4,000 \text{ of Year 3 cash receipts}\}$ . Accordingly, the amount deferred is US \$8,000 (\$10,000 – \$2,000).

**QUESTION: 108**

An entity sells inventory for US \$80,000 that had an inventory cost of U'; \$40,1: X11 i1: i The terms of the sale involve payments receivable of US \$10,000 in the first year, 11F; \$45,000 in the second year, and US \$25,000 in the third year. The buyer of the inventory is a new firm with no credit history. If the cost-recovery method of revenue recognition is used, the amount of gross profit to be recognition in the second year is

- A. US \$0
- B. US \$5,000
- C. US \$15,000
- D. US \$45,000

**Answer: C**

The profit recognized in the second year equals the cumulative payments received minus the seller's cost, or US \$15,000  $[(\$10,000 + \$45,000) - \$40,000]$ .

**QUESTION: 109**

When a right of return exists, an entity may recognize revenue from a sale of goods at the time of sale only if

- A. The amount of future returns can be reliably estimated.
- B. The seller retains the risks and rewards of ownership.
- C. The buyer resells the goods.
- D. The seller believes returns will not be material.

**Answer: A**

One condition for condition of revenue from the sale of goods is the transfer of the significant risks and rewards of ownership. Retention of significant risk may occur when, for example, the buyer may rescind the purchase for a reason stipulated in the contract and the buy, is uncertain about the probability of return. However if the entity can reliably estimate future returns and recognize a liability for returns based on experience and other pertinent information, revenue may be recognized at the time of sale if the other conditions for revenue recognition are also met.

**QUESTION: 110**

If receivables transferred with recourse qualify for derecognition, the proceeds from the transfer are

- A. Accounted for as a collateralized borrowing.
- B. Recorded at fair value for the assets obtained and liabilities incurred.
- C. Recorded at the historical cost of the assets obtained.
- D. Reduced by the fair value of the recourse obligation.

**Answer: D**

The entity derecognizes financial assets if it has transferred substantially all of the risks and rewards of ownership. Derecognition also is appropriate when the entity neither has transferred nor retained substantially all the risks and rewards of ownership, providing the entity does not have control. After derecognition, periodic profit or loss will include the difference between the carrying amount transferred and the proceeds, plus or minus any prior adjustment reflecting the fair value of the asset that had been reported in equity. If a new financial asset is created or a financial liability is assumed, the calculation is adjusted for the fair value of the asset or liability. Thus, the proceeds of the sale are reduced by the fair value of the resource obligation (a new financial liability). When the transfer does not meet these criteria, the transfer is accounted for as a collateralized borrowing.

**QUESTION: 111**

A transferor entity most likely should continue to recognize a transferred financial asset if the

- A. Transferor may reacquire the asset, and the asset is readily obtainable in the market
- B. Transferee may sell the full fair value of the asset
- C. Transferor has an option to reacquire the asset, and the reacquisition price is fair value
- D. Transferor is entitled and obligated to repurchase the asset, and the transferee receives a lender's return.

**Answer: D**

An entity derecognizes a financial asset if it has transferred substantially all of the risks and rewards of ownership. Derecognition also is appropriate when the entity neither has transferred nor retained substantially all the risks and rewards of ownership, providing the entity does not have control. A transferor does not derecognize the financial asset if it is entitled and obligated to repurchase or redeem the asset, and the terms of this transaction in effect allow the transferee to obtain a lender's return on the assets it receives in exchange for the transferred financial asset.

**QUESTION: 112**

Derivatives that are not hedging instruments are always classified in which category of financial instruments?

- A. Financial assets or liabilities held for trading
- B. Held-to-maturity investments.
- C. Loans and receivables.
- D. Available-for-sale financial assets.

**Answer:** A

Financial assets or liabilities at fair value through profit or loss include those held for trading. Regardless of intent, a financial asset is held for trading if it is included in a portfolio with a recent pattern of short-term profit taking. Derivatives also are deemed to be held for trading unless they are designated and effective as hedging instruments.

**QUESTION:** 113

Subsequent to their initial recognition, which financial assets with quoted market prices in an active market are measured at fair value?

	<u>Held-to-Maturity Investments</u>	<u>Loans and Receivables</u>	<u>Available-for-Sale Financial Assets</u>	<u>Financial Assets Held for Trading</u>
A.	Yes	Yes	Yes	No
B.	Yes	Yes	No	No
C.	No	No	Yes	Yes
D.	No	No	No	Yes

**Answer:** C

Subsequent measurement of financial assets is normally at fair value. Thus, derivative, available-for-sale, and held-for-trading financial assets are measured at fair value. Loans and receivables and held-to-maturity investments are measured at amortized cost using the effective interest rate method. Unquoted equity instruments whose fair value is not reliably measurable are reported at cost.

**QUESTION:** 114

Assuming an available-for-sale financial asset that is not part of a hedge is remeasured to fair value at the balance sheet, the gain or loss not arising from foreign exchange transactions or impairment

- A. Must be recognized in profit or loss.
- B. Must be recognized directly in equity.
- C. May be recognized in profit or loss or directly in equity.
- D. Must be recognized in profit or loss if the result is a loss and directly in equity if the result is a gain.



**Answer: B**

A gain or loss on an available-for-sale financial asset that is not part of a hedge is recognized directly in equity through the statement of changes in equity except for impairment losses and foreign exchange gains and losses. The accumulated remeasurement gain or loss is included in profit or loss when the asset is derecognized.

**QUESTION: 115**

If bonds payable with a carrying amount equal to par value are refunded by use of a call provision, the call premium of the refunded issue should be

- A. Amortized over the remaining original life of the extinguished issue.
- B. Amortized over the life of the new issue.
- C. Recognized currently in profit or loss as an extraordinary item\_
- D. Recognized currently in profit or loss.

**Answer: D**

An entity should remove a financial liability from its balance sheet only when it is extinguished, for example, when the creditor is paid. The difference between the carrying amount and the amount paid should be included in profit or loss for the period.

**QUESTION: 116**

An entity most likely may derecognize a financial liability if it

- A. Transfers amounts to a trust to be used to repay the obligation.
- B. Exchanges debt instruments with the lender with substantially similar terms.
- C Exchanges debt instruments with the lender with substantially different terms.
- D Transfers amounts in a transaction that meets the requirements of an in-substance defeasance.

**Answer: C**

Derecognition of a financial liability (or a part) occurs only by means of extinguishment\_ This condition is satisfied only when the debtor pays the creditor or is legally released from primary responsibility either by the creditor or through the legal process. An extinguishment and derecognition of the old debt and recognition of new debt occurs when the borrower and lender exchange debt instruments with II substantially different terms, that is, when the respective discounted cash flows differ by at least 10%.

**QUESTION: 117**

An entity has a US \$100,000 liability on the books. In 12 months, US \$110,000 will be

due, including 10% interest. The entity negotiates settlement of the debt today by exchanging customer receivables with a carrying amount of US \$90,000. What is the journal entry today?

- A. Liability US \$110.000  
Receivables US \$99.000  
Gain 11.000
- B. Liability US \$100.000  
Receivables US \$99.000  
Gain 1.000
- C. Liability US \$110.000  
Receivables US \$90,000  
Gain 20,000
- D. Liability US \$100,000  
Receivables US \$90,000  
Gain 10.000

**Answer:** D

An entity may derecognize a financial liability when it is extinguished\_ This condition is met when the debtor discharges the debt by paying the creditor, such as with cash, other financial assetse.g., receivables), goods, or services. Consequently, the liability should be debited for its US \$100.000 balance Receivables with a US \$90.000 balance are given up, so that account should be credited. The difference is again.

**QUESTION:** 118.

Debtor Bank on a 10-year, 15% note in the amount of US \$100,000, plus US \$30,000 accrued interest\_ Because

- if financial difficulty. Debtor has been unable to make annual interest payments for the past 2 years, and the n-ate is due today. Accordingly, Bank legally agreed to restructure Debtor's debt as follows:

- The US \$30.000 of accrued interest was forgiven.
- Debtor was given 3 more years to pay off the debt at 8% interest. Payments are to be made annually at year-end. The present value of the payments using the prevailing rate for similar instruments of an issuer with a similar credit rating is US \$84.018.

At the date of the restructuring, Debtor properly records

- A. A loss of US \$30.000.
- B. A gain of US \$30.000\_
- C. A gain of US \$45,982.
- D. No gain or loss because no extinguishments occurred.

**Answer: C**

Derecognition of a financial liability (or a part) occurs only by means of extinguishment. This condition is satisfied only when the debtor pays the creditor or is legally released from primary responsibility either by the creditor or through the legal process. An extinguishment and derecognition of the old debt and recognition of new debt occurs when the borrower and lender exchange debt instruments with substantially different terms, that is, when the respective discounted cash flows differ by at least 10%. A substantial modification of terms is also accounted for as an extinguishment. The difference between the carrying amount (including unamortized costs) of a liability (or part) that has been extinguished or transferred and the amount paid is included in profit or loss. This transaction qualifies as an extinguishment based on a substantial modification of terms because the discounted cash flow from the old debt (US \$130,000 due immediately) and the new debt (given as US \$84,018) differ by at least 10%. Hence, the amount included by Debtor in profit or loss at the date of the restructuring is a US \$45,982 gain (\$130,000 - \$84,018). That is, the difference between the carrying amount extinguished and the amount paid (the present value of the new debt instrument determined by discounting the cash outflows at the prevailing rate for similar instruments of an issuer with a similar credit rating). The entry is to debit the extinguished liability for accrued interest and principal (US \$130,000), debit discount on note payable (US \$15,982), credit note payable (US \$100,000), and credit gain (US \$45,982).

**QUESTION: 119**

In November of the current year, the vice-president of a local bank reviews the bank's mortgage portfolio prior to the December 31 year-end. The bank's largest client has mortgages on buildings in three cities. The client has incurred net losses for the past 3 years and is now experiencing serious cash flow problems. For the past 6 months, no payments have been made on any of the three mortgages. The vice-president reluctantly concludes that it is probable that the full amount of principal and interest will not be collected. What is the impact of this conclusion on the local bank's current year financial statements?

- A. No accounting or disclosure of a possible loss in value is necessary.
- B. Contingency note disclosure of a possible impairment is required.
- C. The carrying amount of the mortgages should be reduced, with a charge directly to retained earnings.
- D. The carrying amount of the mortgages should be reduced, with a charge to the income statement

**Answer: D**

A financial asset, such as a lender's mortgage receivable, is impaired if its carrying amount at the balance sheet date exceeds its estimated recoverable amount. If it is probable that all amounts due on such a held-to-maturity investment (a financial asset carried at amortized cost) cannot be collected, the loss should be included in profit or loss. The loss equals the difference between the carrying amount and the present value of

the expected future cash flows discounted at the original effective interest rate. The carrying amount of the asset should be reduced to its estimated recoverable amount directly or by crediting an allowance account

**QUESTION: 120**

An entity often factors its accounts receivable. The finance company requires an 8% reserve and charges a 1.5% commission on the amount of the receivable. The remaining amount to be advanced is further reduced by an annual interest charge of 16%. What proceeds (rounded to the nearest dollar) will the entity receive from the finance company at the time a US \$110,000 account that is due in 60 days is turned over to the finance company?

- A. US \$81,950
- B. US \$83,630
- C. US \$96,895
- D. US \$99,550

**Answer: C**

The factor will hold out US \$8,800 (\$110,000 x 8%) as a reserve against returns and allowances and US \$1,650 (\$110,000 x 1.5%) as a commission. That leaves US \$99,550 to be advanced to the seller. However, interest at the rate of 16% annually is also to be withheld. For 60 days that interest would amount to approximately US \$2,655 (assuming a 360-day year). The proceeds to be given to the seller equal US \$96,895 (\$99,550 - \$2,655).

**QUESTION: 121**

Subsequent measurement of trade receivables is at

- A. Fair value through profit or loss.
- B. Cost.
- C. Amortized cost
- D. Fair value through equity.

**Answer: C**

According to IAS 39, subsequent measurement of financial assets (including derivatives that are assets) is at fair value with certain exceptions. Loans and receivables and held-to-maturity investments are measured at amortized cost using the effective interest method. Unquoted equity instruments whose fair value is not reliably measurable are reported at cost.

**QUESTION: 122**

A plot of land is acquired in exchange for US \$250,000 cash and a noninterest-bearing note with a face amount of US \$1,000,000 on January 1 of the current year. The US \$1,000,000 is payable in installments of US \$250,000 each, with the first installment due December 31 of the current year. With regard to imputing interest on this note.1) what market rate should be used to account for interest for the current year and2) what should be done in future years when there is a change in prevailing interest rates?

	(1) Market Rate Used to Compute Interest Expense for the current year	(2) Impact of Change in Prevailing Interest Rates in Future Periods on Rate Used to Account for This Note
A.	Rate prevailing at January 2	Ignore change in rate
B.	Rate prevailing at January 2	Use new market rate
C.	Rate prevailing at December 31	Ignore change in rate
D.	Rate prevailing at December 31	Use new market rate

**Answer: A**

Determination of the imputed interest rate is made at the time the debt instrument is issued. Subsequent to initial recognition, most financial liabilities are measured at amortized cost using the effective interest method. Exceptions are those1) classified as at fair value through profit or loss or2) arising when a transfer of a financial asset does not qualify for derecognition or is accounted for on a continuing involvement basis(AS 39). Consequently, a change in the prevailing market rate does not affect the measurement of the noninterest-bearing note given for the land.

**QUESTION: 123**

An entity issued a noninterest bearing note payable due in 1 year in exchange for land. The fair value of the land is not reliably determinable. Which of the following statements is true concerning the accounting for the transaction?

- A. The land should be recorded at the future value of the note, and interest should be imputed at the prevailing rate on similar notes.
- B. No interest should be recognized on the note, and the land should be recorded at the present value of the note
- C. Interest on the note should be imputed at the prime rate, and the land should be recorded at the discounted value of the note.
- D. Interest on the note should be imputed at the prevailing rate for similar notes, and the land should be recorded at the present value of the note.

**Answer: D**

When a financial liability is initially recognized, the entity should measure it at its cost a

is the fair value of the consideration received. The fair value ordinarily is determined by reference to the transaction price or other market prices. If these prices are not reliably determinable, the fair value is estimated by discounting the future cash payments at an imputed rate equal to the prevailing market rate for a similar instrument (e.g., similar as to currency, term, and type of rate) of an issuer with a similar credit rating.

**QUESTION: 124**

Futures and option contracts are examples of what type of financial instruments?

- A. Nonderivatives.
- B. Underlyings.
- C. Derivatives.
- D. Equity instruments.

**Answer: C**

A derivative is a financial instrument whose value changes with the change in the underlying. It requires little or no investment and is settled in the future. Examples are futures, forward, swap, or option contracts. The underlying is a specified interest rate, security price, foreign currency exchange rate, price index, commodity price, etc.

**QUESTION: 125**

Nonderivative financial instruments that have 1) fixed or determinable payments, 2) a fixed maturity, and 3) are held by the investing entity with a positive intent and ability to hold until maturity are what category of financial instruments?

- A. Held-to-maturity investments.
- B. Available-for-sale financial assets.
- C. Financial assets or liabilities held for trading.
- D. Fair value hedges.

**Answer: A**

Financial instruments are classified in three categories. Held-to-maturity investments are nonderivatives that have fixed or determinable payments and a fixed maturity. The entity must have a positive intent and ability to hold such investments to maturity. The other categories are financial assets or liabilities held for trading and available-for-sale financial assets.

**QUESTION: 126**

Which of the following is not a criterion for hedge accounting?

- A. The hedge is expected to be highly effective and can be reliably measured.
- B. The hedge is assessed only at its inception.
- C A forecast transaction subject to a cash flow hedge must be highly probable.
- D. The hedge is formally designated and documented at its inception.

**Answer: B**

An entity can mitigate a possible loss by using hedges to offset risk. Thus, an entity is said to hedge its financial positions. One of the criteria for hedge accounting is that the hedge be continually assessed and determined to have been effective. Thus, it is not assessed only at its inception.

**QUESTION: 127**

To mitigate a possible loss and offset risk, an entity can use derivatives or other hedging instruments. Which of the following?

	<u>Fair Value Hedge</u>	<u>Cash Flow Hedge</u>
A.	No	No
B.	No	Yes
C.	Yes	Yes
D.	Yes	No

**Answer: D**

A fair value hedge is a hedge of the exposure to changes in fair value of a recognized asset or liability or unrecognized firm commitment The exposure must be due to a given risk and be, able to affect profit or loss. A cash flow hedge is a hedge of the exposure to variability in cash flows that1) is due to a given risk associated with a recognized asset or liability or a highly probable forecast transaction and2) could affect profit or loss.

**QUESTION: 128**

A cash flow hedge mitigates risk exposure due to variability in cash flows associated with which of the following?

	<u>Unrecognized Firm Commitment</u>	<u>Remotely Possible Forecast Transaction</u>
A.	No	Yes
B.	No	No
C.	Yes	Yes
D.	Yes	No

**Answer: B**

A cash flow hedge is a hedge of exposure to variability in cash flows that1) is due to a given risk associated with a recognized asset or liability or a highly probable forecast transaction and2) could affect profit or loss. A fair value hedge is a hedge of the exposure to changes in fair value of are recognized asset or liability or an unrecognized firm

commitment. Thus, a cash flow hedge is associated with neither an unrecognized firm commitment nor a remotely possible forecast transaction.

Illustrated below is a perpetual inventory card for the current year.

Date	Units Purchased	Units Sold	Units Balance
January 1			0
January 12	1,000 @ US \$2.00		1,000
March 15		300	700
May 5	500 @ US \$2.20		1,200
July 8		500	700
November 24	1,000 @ US \$1.65		1,700

**Additional Information**

- The entity had no opening inventory.
- The Items sold on March 15 were purchased on January 12.
- The items sold on July 3 war purchased on May 5

**QUESTION: 129**

The ending inventory balance under the first-in. first-out(FIFO) method of inventory valuation is

- A. US \$3,050
- B. US \$3,150
- C. US \$3,230
- D US \$3.430

**Answer: B**

Under the FIFO method, the 1.700 units of ending inventory are valued at the most recent prices. Ending inventory is assumed to include 1.000 units purchased November 24. 500 units purchased May 5. and 700 units purchased January 12. Hence, the ending inventory is US \$3.150 [(1 .000 x \$1 65) +500 \$2.21') +700 x \$2.00)].

Date	Units Purchased	Units Sold	Units Balance
January 1			0
January 12	1,000 @ US \$2.00		1,000
March 15		300	700
May 5	500 @ US \$2.20		1,200
July 8		500	700
November 24	1,000 @ US \$1.65		1,700

**Additional Information**

- The entity had no opening inventory.
- The Items sold on March 15 were purchased on January 12.
- The items sold on July 3 war purchased on May 5



**QUESTION: 130**

The cost of goods sold under the specific identification method of inventory valuation is

- A. US \$1,;
- B. US \$1,'. 1
- C. US. \$1,1z.1
- D. US \$1.+1 ,1I

**Answer: D**

Of the 800 units sold during the period, the 300 units said on March 15 were purchased on January 12 at a cost of US \$2.00 per unit. The remaining 500 units were purchased on May 5 at a cost of US \$2.20 per unit. The cost of goods sold under the specific identification method is therefore US \$1.700 [(300 units x \$2.00) +500 units ,, \$2.20)].

**QUESTION: 131**

A retail entity maintains a markup of 25 % based on cost. The entity has the following information for the current year:

Purchases of merchandise	US \$690,000
Freight-in on purchases	25,000
Sales	900,000
Ending inventory	80,000

Beginning inventory was

- A. US \$40,000
- B. US \$85,000
- C. US \$110,000
- D. US \$265,000

**Answer: B**

Cost of goods sold equals beginning inventory, plus purchases including freight-in), minus ending inventory. Given that sales reflect 125% of cost, cost of goods sold must equal US \$720,000 \$900.000 sales Consequently the beginning inventory must been US \$85,000 \$720,000 CGS \$80,000 E- \$690,000 purchases – \$25,000 freight-in)

**QUESTION: 132**

Which inventory pricing method generally approximates current cost for each of the following?

	<u>Ending Inventory</u>	<u>Cost of Goods Sold</u>
A.	FIFO	FIFO
B.	LIFO	FIFO
C.	FIFO	LIFO
D.	LIFO	LIFO

**Answer: C**

FIFO assigns the most recent purchase prices to ending inventory and the earliest purchase prices to cost of goods sold. LIFO uses the earliest acquisition costs to price the ending inventory. It is not permitted by the IFRSs. Thus, FIFO approximates current cost for ending inventory, and LIFO approximates current cost of goods sold.

**QUESTION: 133**

The cost of materials has risen steadily over the year. Which of the following methods of estimating the ending balance of the materials inventory account will result in the highest profit, assuming all other variables remain constant?

- A. Last-in, first-out (LIFO).
- B. First-in, first-out (FIFO).
- C. Weighted average.
- D. Specific identification.

**Answer: B**

Profit will be higher when cost of goods sold is lower, other factors held constant. Cost of goods sold equals beginning inventory, plus purchases, minus ending inventory. Accordingly, cost of goods sold will be lowest when the ending inventory is highest. Ending inventory is highest under FIFO because the older, less expensive items are deemed to have been sold, leaving the more expensive items in the ending inventory.

**QUESTION: 134**

A physical inventory count showed an entity had inventory costing US \$1,000,000 on hand at December 31, Year 1. Excluded from this amount were the following:

- Goods costing US \$82,000, shipped to a customer free on board (FOB shipping point) on December 28, Year 1. They were expected to be received by the customer on January 4, Year 2.
- Goods costing US \$122,000, shipped to a customer free on board (FOB destination) on December 30, Year 1. They were expected to be received by the customer on January 5, Year 2.

Compute the correct ending inventory to be reported on the shipper's balance sheet at December 31, Year 1.

- A. US \$1,000,000
- B. US \$1,082,000
- C. US \$1,122,000
- D. US \$1,204,000

**Answer: C**

The goods shipped FOB shipping point should be counted in the buyer's, not the seller's, inventory because title and risk of loss pass at the time and place of shipment. These goods were properly excluded from ending inventory. The goods shipped FOB destination were improperly excluded from the seller's ending inventory. The title and risk of loss did not pass until the time and place where the goods reached their destination and were duly tendered. Thus, the correct ending inventory is US \$1,22,000  $\$1,000,000$  beginning balance + 122,000 goods shipped FOB destination.

**QUESTION: 135**

When a perpetual inventory system is used and a difference exists between the perpetual inventory amount balance and the physical inventory count, a separate entry is needed to adjust the perpetual inventory amount. Which of the following demonstrates that adjusting entry?

- A. Inventory over and short  
Inventory
- B. Extraordinary loss due to write-down of inventory  
Inventory
- C. Extraordinary loss due to write-down of inventory Allowance for inventory shortages
- D. Cost of goods sold Retained earnings appropriated for shortages

**Answer: A**

The entry to record a write-down is a debit to inventory over and short and a credit to inventory. This amount is reported as an adjustment of cost of goods sold or as an other expense on the income statement.

**QUESTION: 136**

An entity had the following selected per-unit data relating to work-in-process:

- Selling price US \$100
- Comparison cost 10
- Historical cost 91
- Replacement cost 108
- Normal gross profit 20
- Selling cost 5

In comparison with historical cost, what will be the per-unit impact on gross profit of

measuring ending inventory.

- A. No effect
- B. Reduction of US %6.
- C. Reduction of US \$26
- D. Increase of US \$5,

**Answer: B**

Inventories are measured at the lower of cost or net realizable value (NRV). NRV equals selling price minus completion and selling costs. Given that historical cost is US \$91 and NRV is US \$84 (price of \$100 – \$10 completion cost – \$5 selling cost), the effect on per-unit gross profit is a reduction of US \$6. This amount is the writedown expensed.

**QUESTION: 137**

An entity started in Year 1 with 200 scent. 1 candles on hand at a cost of US \$3.50 each. These candles sell for US \$7.00 each. The following schedule represents the purchases and sales of candles during Year 1:

Transaction Number	Quantity Purchased	Unit Cost	Quantity Sold
1	---	---	150
2	250	US \$3.30	---
3	---	---	100
4	200	3.10	---
5	---	---	200
6	350	3.00	---
7	---	---	300

If the entity uses periodic FIFO inventory pricing, the gross profit for Year 1 would be

- A. US \$2,755
- B. US \$2,805
- C. US \$2,854
- D. US \$2,920

**Answer: B**

The FIFO method assumes that the first goods purchased are the first goods sold and that ending inventory consists of the latest purchases. Moreover, whether the inventory system is periodic or perpetual does not affect FIFO valuation. The cost of goods sold is US \$2,445 [(beginning inventory 200 units x \$3.50) - purchases [(250 units x \$3.30) 200 units x \$3.10] - 350 units x \$3.00] - ending inventory 250 units x \$3.00]. Thus, the gross profit for Year 1 using FIFO is US \$2,805 [sales 750 units x \$7.00] - cost of goods sold of \$2,445].

**QUESTION: 138**

The following data are available from the records of a department store for the year ended December 31, Year 1:

	<u>At cost</u>	<u>At retail</u>
Merchandise inventory, as of January 1, Year 1	US \$ 9,000	US \$13,000
Purchases	33,000	46,000
Markups (net)		1,000
Markdowns (net)		4,000
Sales		48,000

Using the retail method to approximate valuation at lower of average cost or net realizable value, the department store's merchandise inventory at December 31, Year 1 is

- A. US \$8,400
- B. US \$3,900
- C. US \$6,100
- D. US \$5,600

**Answer: D**

The version of the retail method that approximates a lower-of-average-cost-or-NRV valuation includes markups but not markdowns in the cost-to-retail ratio. Thus, the cost of the inventory at December 31, Year 1 is US \$5,600.

	<u>Cost</u>	<u>Retail</u>
Inventory, January 1, Year 1	US \$ 9,000	US \$ 13,000
Purchases	33,000	46,000
Markups, net		1,000
	<u>US \$42,000</u>	<u>60,000</u>
Sales		(48,000)
Markdowns, net		(4,000)
Inventory at retail, December 31, Year 1		<u>8,000</u>
Cost-to-retail ratio (US \$42,000 ÷ \$60,000)		<u>× .70</u>
Inventory at cost, December 31, Year 1		<u>US \$ 5,600</u>

**QUESTION: 139**

An internal auditor performs an analytical procedure to compare the gross margins of various divisional operations with those of other divisions and with the individual division's performance in previous years. The internal auditor notes a significant increase in the gross margin at one division. The internal auditor does some preliminary investigation and also notes that there were no changes in products, production methods, or divisional management during the year. The most likely cause of the increase in gross margin is

- A. An increase in the number of competitors selling similar products.
- B. A decrease in the number of suppliers of the material used in manufacturing the product

- C. An overstatement of year-end inventory.  
 D. An understatement of year-end accounts receivable.

**Answer: C**

An overstatement of year-end inventory results in an increase in the gross marginsales - cost of sales). Overstating ending inventory understates cost of sales. Copper Co. had the pre-closing trial balance at December 31 shown below. Additional information: The balance of opening inventory was US \$140,000.

The long-term debt pays interest at a rate of 10% per annum, payable every 12 months. The debt was issued on July 1 of the current year and originally had 5 years to maturity. The assets classified as property, plant, and equipment have a 10-year estimated useful life and were 1 year old at the start of the current year Straight-line depreciation is used.

Cash	US \$ 80,000
Accounts receivable	100,000
Inventory	230,000
Gross property, plant, and equipment	600,000
Accumulated depreciation	60,000
Accounts payable	200,000
Long-term debt	1,000,000
Share capital	2,000,000
Retained earnings (Jan. 1)	500,000
Sales revenue	750,000
Purchases	530,000
Administrative expenses	200,000

**QUESTION: 140**

On the year-end financial statements, the company will report cost of goods sold of

- A US \$440,000  
 B. US \$620,000  
 C. US \$670,000  
 D. US \$900,000

**Answer: A**

Cost of goods sold equals begin rag inventory. plus purchases. m us ending inventory. Hence cost of goods sold is US \$440,000\$ 140,000 + \$530,000 - \$230,000).

**QUESTION: 141**

ABC Manufacturing Company ships merchandise U s \$40,000 on consignment to XYZ Stores. ABC pays US \$3,000 of freight costs to a transport company, and XYZ pays US \$2,000 for local advertising costs that are reimbursable from ABC. By the end of the period the three, fourths of the consigned merchandise has been sold for US \$50,000 cash. XYZ notifies ABC of the sales, retains a 10% commission and the paid advertising costs and remits the cash due ABC. Select the journal entry that appropriately records the notification of sale and the receipt of cash by ABC.

- A. Cash US \$40,000  
 Advertising expense 2,000  
 Commission expense 5,000  
 Freight expense 3,000  
 Revenue from consignment sales US \$50,000
- B. Cash US \$43,000  
 Advertising expense 2,000  
 Commission expense 5,000  
 Revenue from consignment sales US \$50,000
- C. Cash US \$40,000  
 Revenue from consignment sales US \$50,000
- D. Cash US \$40,000  
 Commission expense 5,000  
 Revenue from consignment sales US \$50,000

**Answer: B**

ABC debits the cash received US \$43,000 [\$50,000 sales - \$2,000 advertising - \$5,000 sales commission]. The advertising and commission expenses are debited for \$2,000 and \$5,000, respectively. Finally, US \$50,000 of gross revenue is credited.

**QUESTION: 142**

The following facts are presented for an entity that uses the retail inventory method\_

	Cost	Retail
Beginning inventory	US \$28,000	US \$40,000
Purchases	126,000	180,000
Sales		170,000
Ending inventory (per physical count) at retail prices		45,000

What is the forgone sales revenue from inventory shrinkage?

- A. US \$3.500  
 B. US \$5.000  
 C. US \$35.000  
 D. US \$45.000

**Answer: B**

The retail inventory method converts ending inventory at retail to cost by applying a cost-retail ratio. The advantage is that a physical inventory can be taken at retail without the necessity of counting individual items at cost. Because this method requires detailed inventory records to be kept at retail, lost sales revenue at retail caused by inventory shrinkage can be calculated using the following retail data:

Beginning inventory	US \$ 40,000
Purchases	<u>180,000</u>
Goods available for sale	\$220,000
Sales	<u>(170,000)</u>
Estimated ending inventory	\$ 50,000
Actual ending inventory	<u>(45,000)</u>
Inventory shrinkage	<u>US \$ 5,000</u>

**QUESTION: 143**

An entity purchased US \$1 .000 gross amount of inventory on account with terms of 2 f discount if paid within 10 days. The seller was responsible for delivery to the shipping point, with freight of US \$30 prepaid by the seller. The entity records purchases at the net amount The journal entry to record payment 8 days after the invoice date is

A. Accounts payable	US \$1,010	
Cash		US \$1,010
B. Accounts payable	US \$980	
Freight-in	30	
Cash		US \$1,010
C. Purchases	US \$1,000	
Freight-in	30	
Accounts payable		US \$1,030
D. Purchases	US \$980	
Freight-in	30	
Accounts payable		US \$1,010

**Answer: A**

Under the net method, the payable is initially credited at the discounted amount Because the payment was within the discount period and freight was prepaid. the buyer's remittance to the seller includes the freight cost of US \$30 and the discounted price of the merchandise  $[\text{US } \$1.000 \times 1.0 - 1.02) = \text{US } \$980]$ , a total of US \$1 .010. An entity with a December 31 year-end purchased US \$2,000 of inventory on account. The seller was responsible for delivery to the shipping point, with freight of US \$50 paid at destination by the buyer. The invoice date was December 27. Year I. and the goods arrived on January 3, Year 2.

**QUESTION: 144**

Now assume the terms required the seller to deliver to the destination instead of the shipping point. What is the correct amount of inventory and freight-in relating to this purchase on the Year 1 financial statements?

	<u>Inventory</u>	<u>Freight-In</u>
A.	US \$0	US \$0
B.	US \$2,050	US \$0
C.	US \$0	US \$50
D.	US \$2,000	US \$50

**Answer: A**

Title and risk of loss passed to the buyer at the destination, and the seller incurred the



erage of delivery to that point. The goods did not arrive until after year-end, so they should not be included in Year 1 inventory. Freight-in should also not be recorded until Year 2.

**QUESTION: 145**

A merchandising company had the following inventory related transactions in its first year of operations:

<u>Date</u>	<u>Purchases in Units</u>	<u>Sales in Units</u>	<u>Balance in Units</u>
Jan. 1	10,000 @ US \$5		10,000
March 1	6,000 @ US \$6		16,000
May 1		3,000	13,000
July 1	8,000 @ US \$6.25		21,000
Sept. 1		12,000	9,000
Nov. 1	5,000 @ US \$7		14,000
Dec. 1		2,000	12,000

If the company uses the first-in-first-out (FIFO) method of inventory valuation, its ending inventory balance (rounded) will be

- A. US \$62,000
- B. US \$70,759
- C. US \$78,750
- D. US \$84,000

**Answer: C**

The first-in-first-out (FIFO) method assumes that the oldest units are used first and the newest units remain in inventory. Because the company has 12,000 units remaining, ending inventory equals US \$78,750 [(5,000 \$7) + (7,000 \$6.25)].

**QUESTION: 146**

The cost of materials has risen steadily over the year. The entity uses its newest materials first when removing items from inventory. Which of the following methods of estimating the ending balance of the materials inventory account will result in the highest profit, all other variables held constant?

- A. Last-in-first-out (LIFO).
- B. First-in-first-out (FIFO).
- C. Weighted average.
- D. Specific identification.

**Answer: B**

The first-in-first-out (FIFO) method assumes that the oldest and hence least costly units are used first, and the newest and most costly items remain in inventory. This method will

result in the highest inventory balance if costs rise steadily during the accounting period. Accordingly, FIFO results in the lowest cost of goods sold and the highest profit.

**QUESTION: 147**

An entity uses the retail method of inventory estimation for interim reporting purposes. Management expects some normal shrinkage in the inventory because of theft. What effect will the failure to consider this shrinkage have on the computation of 1) the cost-retail ratio, and 2) the estimated ending inventory at retail?

	(1) Effect on Cost- Retail Ratio	(2) Effect on Estimated Ending Inventory at Retail
A.	No effect	No effect
B.	No effect	Overstatement
C.	Overstatement	Overstatement
D.	Overstatement	Understatement

**Answer: B**

The retail method of inventory estimation applies a cost-retail ratio to the ending inventory at retail to determine ending inventory at cost. For example, a popular method calculates the ratio as goods available for sale at cost divided by goods available at retail, with markups but not markdowns included in the calculation of the retail amount. Normal inventory is subtracted from the retail amount of goods available because they are not available. However, abnormal amounts of theft, etc., are removed from the cost and retail amounts. The reason for the difference in treatment is that normal but not abnormal inventory losses are anticipated and included in the selling retail value. Accordingly, failure to account for normal inventory shrinkage has no effect on the calculated cost-retail ratio but overstates ending inventory at retail.

**QUESTION: 148**

Under IAS 2, Inventories, all of the following should be decided when reporting inventories except

- A. The use of the lower-of-cost-or-net-realizable-value method, if applicable.
- B. The cost formulas used.
- C. The carrying amount of inventories in classifications appropriate to the entity.
- D. An estimated amount of obsolete inventory included in the total inventory valuation.

**Answer: D**

According to IAS 2, Inventories, disclosures about inventories include, for example, the accounting policies applied in measuring inventories, including the cost formulas used, total carrying amount; carrying amount for each classification appropriate to the entity; carrying amount of items carried at fair value minus costs to sell; amount of any reversal

of write downs as income; reasons for such a reversal; and carrying amount of inventory pledged as security. Thus, is, disclosures under IAS 2 include the carrying amount of inventories carried at NRV, not the amount of ate inventory.

**QUESTION: 149**

An entity had 1,000 units of opening inventory that cost US \$10 per unit. On May 1, 1,000 units were purchased at a cost of US \$11 each, and on September 1 another 1,000 units were purchased at a cost of US \$12 each. If 2,000 units were sold during the year, the company will report cost of goods sold of List A if the List B method of inventory valuation is used.

	List A	List B
A.	US \$22,000	LIFO
B.	US \$23,000	Weighted average
C.	US \$21,000	FIFO
D.	US \$22,000	FIFO

**Answer: C**

Under FIFO, the first items purchased are presumed to be the first sold. Given that 3,000 units were available and 2,000 units were sold, FIFO cost of goods sold must have been US \$21,000 [(1,000 × \$10) + (1,000 × \$11) May 1 purchase].

**QUESTION: 150**

Which of the following changes in accounting policies resulting from a significant change in the expected pattern of economic benefit will increase profit?

- A. A change from FIFO to LIFO inventory valuation when costs are rising.
- B. A change from FIFO to weighted-average inventory valuation when costs are falling.
- C. A change from accelerated to straight-line depreciation in the later years of the depreciable lives of the assets.
- D. A change from straight-line to accelerated depreciation in the early years of the depreciable lives of the assets.

**Answer: B**

According to IAS 16, Property, Plant, and Equipment, a change in depreciation method resulting from a significant change in the expected pattern of benefits is accounted for as a change in estimate, that is, prospectively. In a period of falling costs, FIFO results in higher cost of goods sold than the weighted-average method. FIFO includes the higher, early in cost of goods sold, whereas the weighted-average method averages the later, lower costs with the higher, earlier costs. Thus, a change from FIFO to weighted-average costing reduces cost of goods sold and increases reported profit.

An entity had the following account balances in the pre-closing trial balance:

Opening inventory	US \$100,000
Closing inventory	150,000
Purchases	400,000
Transportation-in	6,000
Purchase discounts	40,000
Purchase allowances	15,000
Returned purchases	5,000

**QUESTION: 151**

The entity had net purchases for the period of

- A. US \$340.111111
- B. US \$346.111111
- C. US \$370.111111
- D. US \$376.111111

**Answer:** Pending. Please put your suggestions to [terry@troytec.com](mailto:terry@troytec.com)

**QUESTION: 152**

If the entity uses the weighted-average method of inventory valuation, cost of goods sold for the period will be

- A. US \$186,978
- B. US \$197,000
- C. US \$228.023
- D. US \$235.000

**Answer:** Pending. Please put your suggestions to [terry@troytec.com](mailto:terry@troytec.com)

**QUESTION: 153**

The following information is available for an entity for the quarter ended March 31. of the current year:

Merchandise inventory, as of	
January 1 of the current year	US \$ 30,000
Sales	200,000
Purchases	190,000

The gross profit margin is normally 200 of sales. What is the estimated cost of the merchandise inventory at March 31. of the current year?

- A. US \$20,000
- B. US \$40,000
- C. US \$60.000
- D. US \$180,000

**Answer: C**

The gross profit margin percentage is given as 20% of sales. Hence, cost of goods sold must have been US \$160,000 [ $\$4110,000 \text{ sales} \times (1 - 0.2)$ ]. The estimated cost of the inventory at March 31 is computed as follows:

Inventory at 1/1	US \$ 30,000
Purchases	190,000
Cost of goods available for sale at 3/31	220,000
Estimated cost of goods sold	(160,000)
Estimated inventory at 3/31	60,000

An entity had the following opening and closing inventory balances during the current

	1/1	12/31
Finished goods	US \$90,000	US \$260,000
Raw materials	105,000	130,000
Work-in-progress	220,000	175,000

The following transactions and events occurred during the current year:

US \$300,000 of raw materials were purchased, of which US \$20,000 were returned because of defects. US \$600,000 of direct labor costs were incurred.

US \$750,000 of production overhead costs were incurred.

**QUESTION: 154**

The cost of goods sold for the current year ended December 31 would be

- A. US \$1,480,111.00
- B. US \$1,000,111.00
- C. US \$1,010,111.00
- D. US \$1,050,000.00

**Answer: A**

An entity had the following opening and closing inventory balances during the current year:

	1/1	12/31
Finished goods	US \$90,000	US \$260,000
Raw materials	105,000	130,000
Work-in-progress	220,000	175,000

The following transactions and events occurred during the current year:

US \$300,000 of raw materials were purchased, of which US \$20,000 were returned because of defects. US \$600,000 of direct labor costs were incurred.

US \$750,000 of production overhead costs were incurred.

**QUESTION: 155**

If the entity's raw materials inventory as of r.~. 'Tiber 31 of the current yearending inventory) was miscounted and the true figure was higher than US \$ one effect on the year-end financial statements would be that

- A. Profit is overstated.
- B. Cost of goods said is overstated.
- C\_ Working capital is overstated.
- D. Cost of goods produced is understated.

**Answer: B**

If the ending inventory of raw materials is understated, r materials used is overstated, cost of goods produced is overstated, and cost of goods sold is overstated.

**QUESTION: 156**

On January 1. a company has no opening inventory balance\_ The following purchases are made during the year:

	Units Purchased	Unit Cost
January 1	5,000	US \$10.00
April 1	5,000	9.00
July 1	5,000	8.00
October 1	5,000	7.50

There are 10.000 units in invo ntory on December 31. If the company uses the first in. first out(FIFO) method of inventory valuation, the ending inventory balance will be

- A. US \$77,500
- B. US \$85,000
- C. US \$86,250
- D. US \$95,000

**Answer: A**

Under first-in, first-out(FIFO) inventory valuation, the 10,000 units in ending inventory are assumed to have been the most recent items purchased. The cost of the most recent 10,000 units purchased is:5,000 units x US \$7.50) +5,000 units x \$8) e US \$77,500.

**QUESTION: 157**

An entity is depreciating an asset with a 5-year useful life. It cost US \$100,000 and has no residual value. If the -List A - method is used, depreciation in the second year will be - List B>

	List A	List B
A.	Sum-of-years'-digits	US \$20,000
B.	Sum-of-years'-digits	US \$40,000
C.	200% diminishing-balance	US \$16,000
D.	200% diminishing-balance	US \$24,000

**Answer:** D

**QUESTION:** 158

Which of the following is not an appropriate basis for measuring the cost of property, plant, and equipment?

- A. The purchase price, freight costs, and installation costs of a productive asset should be included in the asset's cost.
- B. Proceeds obtained in the process of readying land for its intended purpose, such as from the sale of cleared timber, should be recognized immediately as income.
- C. The costs of improvements to equipment incurred after its acquisition should be added to the asset's cost if they increase future service potential.
- D. All costs incurred in the construction of a plant building, from excavation to completion, should be considered as part of the asset's cost.

**Answer:** B

Accordingly, items of property, plant, and equipment (PPE) that meet the recognition criterion are initially measured at cost. The cost includes the purchase price (minus trade discounts and rebates, plus purchase taxes) and the directly attributable costs of bringing the assets to working condition for their intended use. Directly attributable costs include site preparation, installation, initial delivery and handling, architect and equipment fees, costs of removing the assets and restoring the site, etc. Accordingly, the cost of land includes the cost of obtaining the land and readying it for its intended uses, but it is inappropriate to recognize the proceeds from the sale of land immediately in profit or loss. They should be treated as reductions in the price of the land.

**QUESTION:** 159

A depreciable asset has an estimated 20% residual value. At the end of the asset's estimated useful life, the accumulated depreciation will equal the original cost of the asset under which of the following depreciation methods?

	Diminishing- Balance	Sum-of-the-Years'- Digits (SYD)
A.	Yes	Yes
B.	Yes	No
C.	No	Yes
D.	No	No

**Answer: D**

At the end of the estimated useful life of a depreciable asset, the amount of accumulated depreciation should equal the depreciable cost (original cost - estimated residual value), regardless of the depreciation method used. Periodic diminishing-balance depreciation is calculated without regard to residual value, but the asset is not depreciated below its residual value. The SYD method uses a depreciable base equal to cost minus residual value.

**QUESTION: 160**

An entity donated land to a municipality for a park. The cost of the land was US \$75,000, and the market value at the time of the donation was US \$125,000, as determined by a professional appraisal. If the entity has not chosen to adopt the cost model for measurement of property, plant, and equipment subsequent to initial recognition, the journal entry to record the donation of the land is

**Answer: C**

An item of PPE is carried at cost minus any accumulated depreciation and impairment losses. Under the allowed alternative treatment, an item of PPE may be carried at a revalued amount equal to fair value at the revaluation date minus any subsequent accumulated depreciation and impairment losses. Land is not depreciated, so it should be carried at its revalued amount. This amount should be determined by a professional appraisal. The revaluation increased the carrying amount and is therefore credited directly to equity (revaluation surplus). Accordingly, the entry is to debit land and credit revaluation surplus for US \$50,000. The entire surplus may be transferred to retained earnings (but not through profit or loss) when the asset is derecognized. Upon derecognition, the asset should be removed from the balance sheet, and the resulting loss (revalued carrying amount of US \$200,000 - 0 net disposal proceeds = US \$200,000) should be included in profit or loss.

**QUESTION: 161**

An entity sells a piece of machinery, for cash, prior to the end of its estimated useful life. The sale price is less than the carrying amount of the asset on the date of sale. The entry that the entity uses to record the sale is



- A. Cash  
Accumulated depreciation -- machinery  
Expense -- disposal of machinery  
Machinery
- B. Cash  
Accumulated depreciation -- machinery  
Income -- disposal of machinery  
Machinery
- C. Cash  
Expense -- disposal of machinery  
Accumulated depreciation -- machinery  
Machinery
- D. Cash  
Machinery  
Accumulated depreciation -- machinery  
Expense -- disposal of machinery

**Answer:** A

The cash account is debited for the amount of the sale proceeds. The machinery account and the related accumulated depreciation account are eliminated by a credit and a debit, respectively. Because the sale price was less than the carrying amount of the asset at the date of sale, a loss on disposal should be recognized in profit or loss. The term "expenses" includes losses.

**QUESTION:** 162

If an entity employs the sum-of-the-years'-digits (SYD) method of depreciation for an asset with an estimated useful life of 4 years, the percentage of the total depreciable cost that will be expensed in the third year is

- A. 10%
- B. 25%
- C. 20%
- D. 70%

**Answer:** C

Under the SYD method, the amount of the depreciable cost that is expensed each year is the remaining useful life at the beginning of that year divided by the sum of the years of useful life. For the third year, the portion expensed is 20% [ $2 / (1 + 2 + 3 + 4)$ ].

**QUESTION:** 163

In making a cash flow analysis of property, plant, and equipment (PPE), the internal auditor discovered that depreciation expense for the period was US \$10,000. PPE with a cost of US \$50,000 and related accumulated depreciation of US \$30,000 was sold for a gain of US \$1,000. If the carrying amount of PPE increased by US \$80,000 during the period, how much PPE was purchased this period?

- A. US \$01,000
- B. US \$100,000

- C. US \$110,000  
D. US\$119,000

**Answer: C**

The carrying amount of the PPE account, net of accumulated depreciation, is increased by the cost of purchases and decreased by the carrying amount of items of PPE sold and depreciation. The net PPE decreased by the carrying amount of items sold, or US\$20,000 (\$50,000 cost - \$30,000 accumulated depreciation), and by the US\$10,000 of depreciation. If PE still increased by US\$80,000, US\$110,000 (\$30,000 total decrease + \$80,000 increase) of equipment must have been purchased.

**Section 2: Sec Two (164 to 296)**

**Details:** Managing resources and pricing

**QUESTION: 164**

Which of the following statements is true for a defined contribution post employment benefit plan?

- A. The employer is required to contribute a certain amount each period based on the plan's formula.  
B. The employer bears the risk of the plan's investment performance.  
C. Post employment benefits received by employees are defined by the plan's formula  
D. The employer and employees are required to contribute equal amounts to the fund.

**Answer: A**

A defined contribution plan provides benefits in exchange for services, provides an account for each participant, and specifies how contributions are to be determined. Post employment benefits depend only on contributions, returns on investment, and allocated forfeitures of other participants' benefits. Thus, employees have the benefit of gain and the risk of loss.

**QUESTION: 165**

The defined post employment benefit obligation of an entity includes benefit obligations to <List A> employees at <List B> salary levels. List A List B

	List A	List B
A.	Vested	Current
B.	Vested	Future
C.	Vested and nonvested	Current
D.	Vested and nonvested	Future

**Answer: D**

The measurement of a postemployment benefit obligation includes estimates of future salary increases, the benefits defined in the plan, the benefits arising from any constructive obligation beyond the terms of the plan, and estimates of future changes in state benefits that affect the level of plan benefits. The possibility that nonvested projected benefits will not vest is a factor in the measurement of the defined benefit obligation, but it does not affect the existence of the obligation.

**QUESTION: 166**

An employee's right to obtain postemployment benefits regardless of whether he remains employed is known as his/her.

- A. Service cost.
- B. Defined benefit plan.
- C. Vested benefits.
- D. Additional minimum liability.

**Answer: C**

Vested benefits are those earned postemployment benefits owed to any employee that are not contingent upon the employee's continued service. Whether benefits have vested affects the measurement of the employer's defined benefit obligation but not its existence. Moreover, vesting affects the accounting for past service cost. Past service cost is amortized as an expense over the average term until the benefits are vested.

**QUESTION: 167**

An employer sponsors a defined postemployment benefit plan. If the given amount of the present value of the defined benefit obligation exceeds the given amount of the fair value of plan assets, the defined benefit liability to be recognized in the balance sheet is greatest when the employer has

- A Net unrecognized actuarial gains and no past service cost.
- B Net unrecognized actuarial losses and no past service cost.
- C Net unrecognized actuarial losses and unrecognized past service cost
- D No unrecognized actuarial gains or losses and unrecognized past service cost.

**Answer: A**

The amount of the defined benefit liability recognized equals the present value of the defined benefit obligation (DBO) at the balance sheet date, plus/minus unrecognized actuarial gains/losses, minus unrecognized past service cost, minus the fair value of plan assets at the balance sheet date. If this amount is negative, it represents an asset. However, the maximum that may be recognized for such an asset is the sum of

unrecognized actuarial losses, unrecognized past service cost, and the present value of future refunds from the plan or reductions in future contributions. Moreover, the application of this section should not result in a gain being recognized solely because of an actuarial loss or past service cost in the current period or in a loss being recognized solely because of an actuarial gain in the current period. Thus, if the excess of the DBO over the fair value of plan assets is constant, net unrecognized actuarial gains will increase the liability. Net unrecognized actuarial losses and unrecognized past service cost decrease the liability.

**QUESTION: 168**

The following information relates to the activity of the defined postemployment benefit plan of Twain Publishers, Ltd.:

Current service cost	US \$120,000
Expected return on plan assets	30,000
Interest cost on defined benefit obligation	40,000
Amortization of net actuarial loss	10,000
Amortization of past service cost	5,000

Twain's expense recognized in the income statement is

- A. US \$120,000
- B. US \$135,000
- C. US \$140,000
- D. US \$145,000

**Answer: D**

Components of the expense are current service cost, interest cost, the expected return on plan assets, service cost recognition in full of vested amounts and amortization of nonvested amounts), and amortization of actuarial loss. Current service cost, interest cost, the amortization of actuarial loss, and the past service cost increase the expense. The expected return on plan assets decreases the expense.

Current service cost	US \$120,000
Return on plan assets	(30,000)
Interest cost	40,000
Amortization of actuarial loss	10,000
Past service cost	5,000
Expense	<u>US \$145,000</u>

**QUESTION: 169**

At the start of its current fiscal year, Emper Corporation amended its defined postemployment benefit plan, resulting in an increase in the present value of the defined benefit obligation (DBO). The benefits become vested after 6 years of service. Past service cost arising from the plan amendment includes US \$400,000 of benefits that

are already vested and US \$200,000 of nonvested benefits. If the average period until vesting is 4 years, the minimum past service cost to be recognized in the first year is

- A. US \$50,000
- B. US \$200,000
- C. US \$450,000
- D. US \$600,000

**Answer: C**

Past service cost is the increase in the present value of the DBO related to prior employee service that arises in the current period from the introduction of or an amendment to postemployment benefits. Accordingly, US \$400,000 should be recognized immediately to reflect the vested benefits and amortization of the nonvested benefits equals US \$50,111 II] \$200,000 - 4), a total of US \$450,000

**QUESTION: 170**

For an entity with a defined postemployment benefit plan, the fair value of plan assets at the beginning of the year was US \$500,000. No unrecognized net cumulative actuarial gain or loss existed. On the last day of the fiscal year, the fair value of plan assets was US \$620,000. Benefits paid equaled US \$100,000, and the entity made US \$120,000 in contributions. The discount rate was 10%, and the expected long-term rate of return on plan assets was 12%. The actual return on plan assets was

- A. US \$50,000
- B. US \$60,000
- C. US \$75,000
- D. US 100,000

**Answer: D**

The actual return on plan assets is equal to the difference between the fair value of plan assets at the beginning and the end of the year adjusted for contributions and benefits paid. Thus, the actual return is US \$100,000.

FV, end of year	US \$620,000
Benefits paid	100,000
Contributions	(120,000)
FV, beginning of year	(500,000)
Actual return	<u>US \$100,000</u>

**QUESTION: 171**

Under a defined contribution pension plan, the amount reported on the balance sheet only if the amount organization has contributed to the pension trust is the amount required.

	List A	List B
A.	An asset	Greater than
B.	An asset	Equal to
C.	A liability	Greater than
D.	A liability	Equal to

**Answer: B**

Under a defined contribution plan, the entity reports on the balance sheet only contribution to the pension trust is greater than the defined,required contribution

**QUESTION: 172**

The present value of future benefits payable as a result of work done before the introduction of, or amendment to, postemployment benefits is the

- A. Additional minimum liability.
- B. Fair value of plan assets.
- C. Defined benefit obligation.
- D. Past service e cost

**Answer: D**

Past service cost is the increase in the present value of the defined benefit obligation (DBO) related to prior employee service that ans., in the current period from the introduction of, or an amendments to postemployment benefits. Past service cost is expensed on a straight-line basis over the average period until vesting. To the extent it is vested upon introduction of, or amendments to, a plan, past service cost is immediately recognized.

**QUESTION: 173**

IFPS 2, Share-Based payment, normally requires entities to account for their share-based employee compensation plans in accordance with which of the following methods?

	Fair-Value- Based Method	Intrinsic-Value- Based Method
A.	Yes	Yes
B.	Yes	No
C.	No	Yes
D.	No	No

**Answer: B**

Entities must account for share-based employee compensation plans in accordance with the fair-value-based method except in the rare cases in which the fair value of the

equity instruments is not reliably measurable at the measurement date the grant date for transactions with employees and those providing similar services). In these rare cases, IFRS 2 requires entities to account for these plans in accordance with the intrinsic-value-based method.

**QUESTION: 174**

The measurement date in accounting for shares issued to employees in share option plans accounted for in accordance with the fair value method prescribed by IFRS 2 is

- A. The date on which options are granted to specified employees.
- B. The earliest date on which both the number of shares to be issued and the option price are known.
- C. The date on which the options are exercised by the employees.
- D. The date the entity forgoes alternative use of the shares to be sold under option

**Answer: A**

Under the fair-value-based method prescribed by IFRS 2, compensation expense is measured at the grant date. This expense is based on the fair value of the award at that date and recognized over the vesting period, the period over which the vesting conditions are expected to be satisfied.

**QUESTION: 175**

On January 2, Year 1, Kine Co. granted Morgan, its president, share options to buy 1,000 shares of Kine's US \$10 per ordinary stock. The options call for a price of US\$20 per share and are exercisable for 3 years following the grant date. Morgan exercised the options on December 31, Year 1. The market price of the shares was US \$50 on January 2, Year 1, and US \$70 on the following December 31. The market price of the shares is followed because the fair value of the option is not reliably measurable, by what net amount should equity increased as a result of the grant and exercise of the options?

- A. US \$ 20,000
- B. US \$30,000
- C. US \$50,000
- D. US \$70,000

**Answer: A**

The measurements January 2, Year 1. At that date, the intrinsic value of the options is US \$30,000 [1,000 shares \$50 market price - \$20 option price)]. This US \$30,000 will be recorded as both compensation expense and options outstanding. The net effect on equity is 0. When the options are exercised the US \$20,000 [1,000 shares \$20 option price)].

This US \$30,000 will be recorded as both compensation expense and options outstanding will be allocated to share capital as US \$30,000 of options are exercised, the US \$20,000 (1,000 shares x \$20 exercise price) cash received and the US \$30,000 of options are exercised price) cash received and the US \$30,000 of options outstanding will be allocated to share capital as US \$10,000 ordinary stock and US \$40,000 additional paid-in capital. The net effect on equity will be a US \$20,000 increase.

**QUESTION: 176**

On January 1, Year 1, International Entity entered into an equity-settled share-based payment transaction with its senior executives. This award of 1,000 share options has a 4-year vesting period. The market prices of the options and the related shares on the grant date are US \$20 and US \$80, respectively. The exercise price is US \$85. Assuming that the vesting conditions were not met for 100 of the options because of unexpected events in Year 4, the entry to debit option expense at

- A December 31, Year 4, is for US \$ 5,000
- B December 31, Year 3, is for US \$ 4,000
- C December 31, Year 2, is for US \$ 5,000
- D January 1, Year 1, is for US \$ 20,000

**Answer: C**

The fair value of each share option is determined at the measurement date, which is the grant date for transactions with employees and others providing similar services. Thus, the fair value of each share option was set at its market price of US \$20 on January 1, Year 1. The periodic expense varies only with the expected number of equity instruments expected to vest. Because the events causing 100 options not to vest occurred unexpectedly in Year 4, the entity presumably at each balance sheet date for the first 3 years of the vesting period that all options would vest. Total expected expense was therefore US \$20,000, and the proportional expense recognized each of the first 3 years was US \$5,000 [(1,000 options x \$20) ÷ 4 years].

**QUESTION: 177**

If a lease agreement transfers substantially all of the risks and rewards of ownership to the lessee, the asset amount is recognized on the lessee's records as a(n) <List A> asset, and the lease is classified as a <List B> lease.

	List A	List B
A.	Tangible	Finance
B.	Intangible	Finance
C.	Tangible	Operating
D.	Intangible	Operating

**Answer: A**



a lease agreement transfers the risks and rewards of ownership of the lessee it is treated as a finance because the transaction is in essence an installment purchase. Accordingly, the lessee records a depreciable asset and a liability. Moreover, IAS 38. Intangible Assets, specifically does not apply to bases that are within the scope of IAS 17, Leases. A finance lease is therefore presented as an item of property, plant, and equipment, that is, as a tangible asset.

**QUESTION: 178**

Finance and operating leases differ in that the lessor

- A. Obtains use of the asset only under a finance lease.
- B. Is using the lease as a source of financing only under an operating lease.
- C. Makes rent payments that are actually installment payments constituting a payment of both principal and interest only under a finance lease.
- D. Finances the transaction through the leased asset only under a finance lease.

**Answer: D**

A lease is a rental or sub-purchase arrangement between a lessor (the owner or seller of the property) and a lessee (the renter or purchaser). The issue in all leases is whether the risks and rewards of ownership have been transferred from the lessor to the lessee. If so, the lease should be accounted for as a sale-purchase, i.e., a finance lease. If the risks and rewards of ownership have not transferred, the lease is a rental arrangement and is called an operating lease. In effect, the lessor provides financing for an installment purchase, and the lessee's payments include both principal and interest components.

**QUESTION: 179**

Which of the following statements about a finance lease is false?

- A. The lessor capitalizes the net investment in the lease.
- B. The lessor records the leased item as an asset.
- C. The lessee records depreciation or finance cost allowance on the leased asset
- D. The lease arrangement represents a form of financing.

**Answer: B**

When a transaction meets the criteria of a finance lease, the lessor removes the leased item from the books and records lease payments receivable regardless of whether the lessor is a manufacturer or dealer. The lessee records and depreciates the leased item under a finance lease.

**QUESTION: 180**

Which of the following leases ordinarily should be classified as a finance lease by the lessee?

	Lease A	Lease B	Lease C	Lease D
Contains a bargain purchase option?	Yes	No	No	No
Lease term is for the major part of the economic life of the leased asset	No	No	Yes	No
Present value of the minimum lease payments is substantially all of the fair value of the leased asset	No	No	No	Yes
Leased asset usable only by lessor without major modification	No	Yes	Yes	No

- A Lease A only
- B Lease B only
- C. Leases A, C and D
- D. Leases C and D only.

**Answer: C**

A lease should be classified as a finance lease by a lessee if it transfers substantially all of the risks and rewards of ownership. A lease is classified at its inception. It normally is classified as a finance lease if, for example, 1) the lease provides for the transfer of ownership of the leased asset by the end of the lease term; 2) the lease contains a bargain purchase option, i.e., the lessee has the option to purchase at a price expected to be sufficiently below the fair value of the exercise date that, at the lease's inception, exercise is reasonably certain; 3) the lease term is for the major part of the economic life of the leased asset; 4) the present value of the minimum lease payments is at least substantially all of the fair value of the leased asset at the inception of the lease; or 5) the leased asset is such that it can be used only by the lessee without major modification. Lease A is a finance lease because the terms of the lease include a bargain purchase option. Lease C passes the economic life test, and lease D passes the recovery of investment test.

**QUESTION: 181**

At the inception of a finance lease, how should the lessee account for guaranteed residual value?

- A As part of minimum lease payments at present value.
- B. As part of minimum lease payments at future value.
- C. As part of minimum lease payments at future value of an annuity due.
- D. As not a part of the lease contract.

**Answer: A**

The lessee records a finance lease as an asset and a liability at the inception of the lease at the fair value of the leased property (not to exceed the present value of the minimum lease payments). The lessee's minimum lease payments include required payments (excluding contingent rent and costs for services and taxes to be paid by and reimbursed to the lessor) during the lease term and the amount of a bargain purchase option. If no bargain purchase option exists, the minimum lease payments equal the sum of the minimum payments payable over the lease term and any amounts guaranteed by the lessee or by a party related to the lessee.

**QUESTION: 182**

KW Ltd. leased equipment under a 4-year, noncancelable lease properly classified as a finance lease. The lease does not transfer ownership or contain a bargain purchase option. The equipment had an estimated economic life of 5 years and an estimated residual value of US \$20,000. Terms of the lease included a guaranteed residual value of US \$50,000. KW initially recorded the leased equipment at US \$240,000, and its depreciation policy for owned assets is to use the straight-line method. Thus, the amount of depreciation that should be charged each year is

- A. US \$55,000
- B. US \$47,500
- C. US \$44,000
- D. US \$38,000

**Answer: B**

Depreciation should be consistent with the accounting policy for owned assets. Absent a reasonable certainty that the lessee will own the asset at the end of the lease term, it should be fully depreciated over the shorter of the useful life or the lease term. The lease does not transfer ownership or contain a bargain purchase option. Accordingly, the period of amortization should be the lease term. In accordance with the straight-line method used by KW for owned assets, the depreciable base for this finance lease is equal to the US \$240,000 initially recorded minus the US \$50,000 guaranteed residual value allocated equally over the 4-year lease term. Consequently, annual depreciation expense is US \$47,500  $[(\$240,000 - \$50,000) \div 4 \text{ years}]$ . On January 1, Plantation Partners is planning to enter as the lessee into the two lease agreements described in the opposite column. Each lease is noncancelable, and Plantation does not receive title to either leased property during or at the end of the lease term. All payments required under these agreements are due on January 1 each year.

Lessor	Lease A	Lease B
Type of property	Oven	Computer
Yearly rental	US \$15,000	US \$4,000
Lease term	10 years	3 years
Economic life	15 years	5 years
Purchase option	None	3,000
Renewal option	None	None
Fair value at inception of lease	US \$125,000	US \$10,200
Unguaranteed residual value	None	2,000
Lessee's incremental borrowing rate	10%	10%
Executory costs paid by	Lessee	Lessor
Annual executory costs	US \$800	US \$500
Present value factor at 10% (of an annuity due)	6.76	2.74

**QUESTION: 183**

Plantation should treat Lease A as a(n)

- A. Finance lease with an initial asset amount of US \$101,400.
- B. Operating lease charging US \$14,200 in rental expense and US \$800 in executory costs to annual operations.
- C. Operating lease charging the present value of the yearly rental expense to annual operations.
- D. Operating lease charging US \$15,000 in rental expense and US \$800 in executory costs to annual operations.

**Answer:D**

Lease a is an operating lease with a \$ 15,000 annuel rental expense with annuel executory costs(e.g.. maintenance,insurance,and taxes)of Us\$800 to be paid by the lessee.an operating lease does not transfer the risks and rewards of ownership to the leasee.lease a is nothing more than a rentl arrangement. Circumstances in which the risks and rewards of ownership are normally deemed to be transferred include the following :the lease tranfers title to the lessee,the lease has a bargain purchase option,the lease term is for the major part of the useful life of the leased asset,the present value of the minimum lease payments is at least substantially all of the asset's fair value,or the asset is usable only by the lessee without major modification. On January1,plantation partners is planning to enter as the lessee into the two lease agreements described in the opposite column.each lease is noncancelable,and plantation does not receive title to either leased property during or at the end of the lease term.all payments required under these agreements are due on January 1 each year.

<u>Lessor</u>	<u>Lease A</u>
Type of property	Oven
Yearly rental	US \$15,000
Lease term	10 years
Economic life	15 years
Purchase option	None
Renewal option	None
Fair value at inception of lease	US \$125,000
Unguaranteed residual value	None
Lessee's incremental borrowing rate	10%
Executory costs paid by	Lessee
Annual executory costs	US \$800
Present value factor at 10% (of an annuity due)	6.76

**QUESTION: 184**

Plantation should treat Lease B as a(n)

- A. Finance lease with an initial asset amount of US \$10,960
- B. Finance lease with an initial asset value of US \$10,200.
- C. Operating lease. charging US \$3,500 in rental expense and US \$500 in executory costs to annual operations.
- D. Finance lease with an initial asset value of US \$9,590.

**Answer: D**

A finance lease is one in which the risks and rewards of ownership are transferred to the lessee. For accounting purposes, the lessee treats a finance lease as similar to the purchase of an asset capitalized at the fair value of the leased asset or, if lower the present value of the minimum lease payments. The lessee's minimum lease payments include the required payments, excluding contingent rent and executory costs (e.g., taxes and insurance), plus any amounts guaranteed by the lessee or a related party. If a bargain purchase option exists, however, minimum lease payments equal the required payments plus the amount of the option. If the present value of the minimum lease payments (calculated without guaranteed amounts or a bargain purchase option) is substantially all of the asset's fair value, the lease normally is accounted for as a finance lease. Given that the executory costs associated with the lease are to be paid by the lessor, a portion of the lease rental price is for those costs, not for the asset. Consequently, the annual minimum lease payment equals the annual payment minus the executory costs, or US \$3,500 (\$4,000 yearly rental - \$500). The present value of the minimum lease payments is therefore US \$9,590 ( $\$3,500 \times 2.74$ ), which is substantially all of the fair value of the asset. Thus, the lease should be capitalized. The appropriate amount of the initial asset value is the present value of the minimum lease payments calculated above.

**QUESTION: 185**

On August 1, Jones leased property to Smith for a 5-year period. The annual US \$20,000 lease payment is payable at the end of each year. The expected residual value at the end of the lease term is US \$10,000. Jones's implicit interest rate is 12%. The cost of the property to Jones was US \$50,000, which is the fair value at the lease date. The present value of an ordinary annuity of 1 for five periods is 3.605. The present value of 1 at the end of five periods is .567. At the inception of the lease, the recorded gross investment is

- A. US \$110,000
- B. US \$100,000
- C. US \$72,100
- D. US \$90,000

**Answer: A**

For a finance lease, the lessor should record the gross investment in the lease at the undiscounted sum of the minimum lease payments (the total of the lessee's required payments, excluding contingent rent and costs for services and taxes to be paid by and reimbursed to the lessor, and any guaranteed residual value) and any Unguaranteed residual value. The gross investment is the same regardless of whether any residual value is guaranteed. The five periodic payments of US \$20,000 equal US \$100,000. The expected residual value including guaranteed and Unguaranteed portions equals US \$10,000. The gross investment should be US \$110,000 (\$100,000 + \$10,000).

**QUESTION: 186**

ABC entities, a manufacturer lessor, leased a machine to XYZ on January 1. The lease meets the criteria for a finance lease. Title to the asset will automatically pass to the lessee at the end of the lease term. Other details are as follow:

Lease term	10 years
Useful life of the asset	10 years
Cost of the leased asset to the lessor	US \$55,000
Annual payment payable at the beginning of each year, beginning January 1	US \$10,000
Implicit interest rate	10%
Present value of an annuity due of 1 discounted for 10 years at 10%	6.7590
Present value of 1 due in 10 years discounted at 10%	.3855

Assuming the fair value of the asset is at least equal to the present value of the minimum lease payments, the journal entry to record the inception of this lease on the lessor's books at January 1 is

A.	Leased machine	US \$67,590		
	Lease liability		US \$57,590	
	Cash		10,000	
B.	Lease payments			
	receivable	US \$90,000		
	Cash	10,000		
	Cost of sales	55,000		
	Inventory		US \$55,000	
	Unearned finance			
	income--leases		45,000	
	Sales		55,000	
C.	Lease payments			
	receivable	US \$90,000		
	Cash	10,000		
	Finance income		US \$32,410	
	Gross profit on lease		12,590	
	Inventory		55,000	
D.	Lease payments			
	receivable		US \$90,000	
	Cash		10,000	
	Cost of sales		55,000	
	Sales			US \$67,590
	Inventory			55,000
	Unearned finance			
	income--leases			32,410

**Answer: D**

For this finance lease, the manufacturer-lessor should record

1. As gross investment, the minimum lease payments because there
2. As net investment, the difference between the gross investment in the lease and unearned finance income (a credit to a liability)
3. As unearned finance income the difference between the gross investment gross investment discounted at the interest rate implicit in the lease)
4. As sales revenue the fair value of the asset or if lower, the present value payments computed at the interest rate implicit in the lease
5. As cost of goods sold, the cost of the leased asset

Because the first payment is made at the inception of the lease, the payment structure is that of annuity due. Sales revenue is therefore equal to the US \$10,000 periodic payment times the present value of an annuity due of 1 discounted for 10 years at 10% (US \$10,000  $\times$  6.7590 = US \$67,590). Given that cash is paid at the beginning of the year, the initial 10,000 cash debit immediately decreases the gross investment in the lease (lease payments receivable) from US \$100,000 to US \$90,000. The cost of the leased asset (US \$55,000) must also be charged to cost of sales and credited to inventory. Finally, at the inception of the lease, unearned finance income equals the difference between the gross investment and the sales price (US \$100,000  $\times$  US \$67,590 = US \$32,410).

**QUESTION: 187**

For a finance lease, the gross investment, lease payments receivable, recorded by the lessor is equal to the

- A Present value of the minimum lease payments minus the unguaranteed residual value accruing to the lessor at the end of the lease term.
- B. Lower of 90% of the present value of the minimum lease payments or the fair value of

the leased asset.

C. Minimum lease payments plus the unguaranteed residual value accruing to the lessor at the end of the lease term

D. Difference between the present value of the minimum lease payments and the unearned finance income.

**Answer: C**

For a finance lease, the lessor should record as the gross investment in the lease the amount of the minimum lease payments (payments plus either any bargain purchase option or any residual value guaranteed by the lessee, a party related to the lessee, or by a financially capable party unrelated to the lessor or the lessee) plus any amounts of unguaranteed residual value. The net investment in the lease is equal to the gross investment minus unearned finance income.

**QUESTION: 188**

Costs incurred by a manufacturer-lessor to negotiate a finance lease are

A. Allocated over the economic life of the leased asset.

B. Expensed when selling profit is recognized.

C. Deferred and allocated over the term of the lease in proportion to the recognition of rental income.

D. Added to the gross investment in the lease.

**Answer: B**

The initial direct cost of negotiating and arranging a finance lease, e.g., commissions and legal fees, are included in the lease receivable and allocated over the lease term. However, similar costs of a manufacturer- or dealer-lessor incurred in negotiating and arranging a lease are excluded from initial direct costs. Thus, they are expensed when the selling profit is recognized (normally the start of the lease term) (IAS 17).

**QUESTION: 189**

A new asset with a fair value of US \$100,000 and a useful life of 10 years is being leased by an entity (lessee). Which one of the situations below will most likely result in classifying the lease on the lessee's books as a finance lease?

A. The lease term is 7 years.

B. The lease term is 8 years.

C. The present value of the minimum lease payments is US \$60,000.

D. The present value of the minimum lease payments is US \$70,000.



**Answer: B**

A lease may be classified as a finance lease or an operating lease by a lessee. A finance lease transfers substantially all of the risk and rewards of ownership of the asset to the lessee. A lease is classified at its inception. It normally is classified as a financial lease if for example,

1. The lease provides for the transfer of ownership of the asset by the end of the lease term.
2. The lease contains a bargain purchase option: i.e. to be sufficiently below the fair value reasonably certain.
3. The lease term is for the major part of the economic life of the asset.
4. The present value of the minimum lease payment lease is at least substantially all of the fair value of the leased asset at the inception of the lease.
5. The leased assets are such that they can be used only by the lessee without major modification.

Thus, a lease term that is  $80\% \times 8 \div 10$  of the economic life of the asset will most likely result in classifying the lease as a finance lease, assuming that 80% is a "major part" of the economic life of the asset.

**QUESTION: 190**

Finance leases are differentiated from operating leases in that finance leases normally

- A Provide for maintenance service at no extra cost to the lessee.
- B Are cancelable at any time upon request by the lessee.
- C Have rental payments that are approximately equal to the amortized cost of the leased asset.
- D Are used only by financial institutions.

**Answer: C**

A lease may be classified as either a finance lease or an operating lease by a lessee. A finance lease transfers substantially all of the risks and rewards of ownership of the asset to the lessee. A lease is classified at its inception. It normally is classified as a finance lease if, for example,

1. The lease provides for the transfer of ownership of the asset by the end of the lease term.
2. The lease contains a bargain purchase option: i.e., the lessee has the option to purchase at a price expected to be sufficiently below the fair value of the exercise date that, at the lease's inception, exercise is reasonably certain.
3. The lease term is for the major part of the economic life of the asset.
4. The present value of the minimum lease payments is at least substantially all of the fair value of the leased asset at the inception of the lease.
5. The leased assets are such that they can be used only by the lessee without major modification. Thus, the rental payments tend to approximate the cost of the leased property.

plus a return on the investment.

**QUESTION: 191**

An entity has US \$100 of current assets, US \$100 of fixed assets, US \$100 of debt, and US \$100 of equity. If it then leases a US \$75 asset in a(n) ,List A, lease agreement, the debt-to-assets ratio of the entity will be <List B>

	List A	List B
A.	Operating	64%
B.	Operating	00%
C.	Finance	50%
D.	Finance	64%

**Answer: D**

If the lease is a finance lease, both the asset and the obligation for future payments are recorded. The entity would have current assets of US \$100, debt of US \$175 (\$100 + \$75), fixed assets of US \$175 (\$100 + 75), and equity of US \$100. Hence, the debt-to-assets ratio would be 64% (US \$175 / 275).

**QUESTION: 192**

Which one of the following statements best describes the asset-liability method of accounting for deferred income taxes?

- A. The amount of deferred tax is based on tax rates in effect when temporary differences originate.
- B. The amount of deferred tax is based on the tax rates expected to be in effect during the periods in which the deferred tax liability (DTL) is settled or the deferrer tax asset (DTA) is realized.
- C. The tax effects of temporary differences are not reported separately but are reported as adjustments to the amounts of specific assets and liabilities and the related revenues and expenses.
- D. The appropriate tax rate to be reported on the income statement is the tax actually levied in that year, meaning no deferred taxes would be reported.

**Answer: B**

A DTA or DTL is measured at the rates expected to apply when it is realized or settled, based on tax laws and rates enacted or substantively enacted as of the balance sheet date. If different rates apply to different taxable profit levels, a DTA or DTL is measured based on the average rates expected to apply in the periods when the temporary differences are expected to reverse. The tax rate or tax base may vary with the manner of recovery or settlement. For example, one tax rate may apply if an asset is sold immediately and another may apply if it is to be recovered through continued use.

**QUESTION: 193**

Which one of the following temporary differences will result in a deferred tax asset?

- A. Use of the straight-line depreciation method for determining accounting profit and an accelerated method for determining taxable profit (tax loss).
- B. Installment sale profits accounted for on the accrual basis for determining accounting profit and on a cash basis for determining taxable profit (tax loss).
- C. Advance rental receipts accounted for on the accrual basis for financial statement purposes and on a cash basis for tax purposes.
- D. Prepaid expenses accounted for on the accrual basis for determining accounting profit and on a cash basis for determining taxable profit (tax loss).

**Answer: C**

A deferred tax asset records the deferred tax consequences attributable to deductible temporary differences and carryforwards. Advance rental receipts accounted for on the accrual basis for determining accounting profit and on a cash basis for determining taxable profit (tax loss) would give rise to a deferred tax asset. The financial statements would show no income and no related tax expense because the rental payments apply to future periods. The tax return, however, would show the rent as income when the cash was received, and a tax would be due in the year of receipt. Because the tax is paid prior to recording accounting profits, it represents an asset that will be realized in the year of receipt. Because the tax is paid prior to recording accounting profits, it represents an asset that will be recognized as an expense when income is finally recorded.

**QUESTION: 194**

At December 31, SCM Ltd., a calendar-year entity, reported the following accounts for which the carrying amount differed from the tax base:

	Carrying Amount	Tax Base
Depreciable assets (net)	US \$150,000	US \$80,000
Deferred rental income	40,000	0

What taxable and deductible amounts are related to these temporary differences? Taxable

	Taxable Amounts	Deductible Amounts
A.	US \$40,000	US \$70,000
B.	US \$70,000	US \$40,000
C.	US \$0	US \$110,000
D.	US \$110,000	US \$0

**Answer: B**

The difference between the carrying amount of an asset or liability and its tax base is a temporary difference (TD). A taxable (deductible) TD results in taxable (deductible)

amounts in the future when the carrying amount of the asset or liability is recovered or settled. The tax base is the amount Attributed for tax purposes to an asset or liability. The tax base of an asset is the amount deductible against Future taxable economic benefits when the asset's carrying amount is recovered. The tax base of a liability is the portion of the carrying amount that will not be deductible against future taxable economic benefits for tax Purposes. The tax base of revenue received in advance (a liability) is the portion of the carrying amount taxable in the future. Thus, the US \$70,000 temporary difference (\$150,000 carrying amount – \$80,000 tax base) related to the depreciable assets is classified as a taxable amount. When income, such as rental income, is taxable before being recognized in accounting profit, future sacrifices to provide the rental service or refund amounts paid will result in future tax deductible amounts when the liability is settled. Thus, the US \$40,000 temporary difference (\$40,000 carrying amount — \$0 tax base) related to the deferred rental Revenue is classified as a deductible amount.

**QUESTION: 195**

Which of the following results in a tax base of zero?

- A. Trade receivables have a carrying amount of US \$1,000, and the related revenue has been included in full in the determination of taxable profit.
- B. A loan receivable has a carrying amount of US \$1,000, and repayment has no tax effects.
- C. Unearned interest revenue has a carrying amount of US \$1,000, and the related interest revenue was included in full in the determination of taxable profit.
- D. Accrued expenses have a carrying amount of US \$1,000, and the related expense has been included in full in the determination of taxable profit.

**Answer: C**

The difference between the carrying amount of an asset or liability and its tax base is a temporary difference (TD). A taxable (deductible) TD results in taxable (deductible) amounts in the future when the carrying amount of the asset or liability is recovered or settled. The tax base is the amount attributed for tax purposes to an asset or liability. The tax base of an asset is the amount deductible against future taxable economic benefits when the asset's carrying amount is recovered. The tax base of a liability is the portion of the carrying amount that will not be deductible against future taxable economic benefits for tax purposes. The tax base of revenue received in advance (a liability) is the portion of the carrying amount taxable in the future. For unearned interest revenue for which the related interest revenue was taxed on a cash basis, the tax base equals zero (US \$1,000 carrying amount - \$1,000 not taxable in the future). An entity has purchased an asset with a 10-year useful life. It will use an accelerated depreciation method for determining taxable profit or tax loss. For determining accounting profit, it will use straight-line depreciation.

**QUESTION: 196**

During the 10-year life of the asset, the entity will report as deferred tax an amount that

- A. Increases steadily for the 10 years.
- B. Is constant.
- C. Increases and then decreases.
- D. Decreases and then increases.

**Answer: C**

The cumulative deferred tax increases, peaks, and then decreases to zero over the life of the asset. In the early years, the asset is depreciated more quickly for tax purposes than for financial reporting purposes. This temporary difference reverses in later years. Hence, in the early years, actual taxes payable will be less than tax expense reported in the financial statements, and a deferred tax liability will be recognized. By the end of the asset's useful life, cumulative actual taxes paid will equal cumulative reported tax expense, so the deferred tax balance will be zero. An entity has purchased an asset with a 10-year useful life. It will use an accelerated depreciation method for determining taxable profit or tax loss. For determining accounting profit, it will use straight-line depreciation.

**QUESTION: 197**

When determining cash flows accruing to the entity, using financial statements prepared for tax purposes will result in

- A. No effect on cash flow amounts.
- B. An overstatement of cash flows throughout the economic life of the asset.
- C. An understatement of cash flows throughout the economic life of the asset.
- D. An overstatement of cash flows in the early years and then an understatement of cash flows in the later years of the economic life of the asset.

**Answer: A**

Cash flows are not affected by the basis of accounting used to prepare the financial statements. Accordingly, whether the financial statements are prepared based on the tax basis, the cash basis, or accounting principles generally accepted in a given country, cash flows should be the same. For example, the cash inflow or outflow resulting from using an accelerated depreciation method to determine actual tax expense or benefit (the amount paid to or refunded by the taxing authority) is completely unaffected by the depreciation method used in the financial statements. However, if cash flows are derived indirectly by adjusting profit or loss reported in the financial statements, different adjustments are necessary to arrive at the same cash flow amounts if different bases of accounting are used in the preparation of the financial statements.

**QUESTION: 198**

Based on its current operating levels, Glucose LLC estimates that its annual level of taxable profit in the foreseeable future will be US \$200,000 annually. Enacted tax rates for the tax jurisdiction in which Glucose operates are 15% for the first US \$50,000 of taxable profit, 25% for the next US \$50,000 of taxable profit, and 35% for taxable profit in excess of US \$100,000. Which tax rate should Glucose use to measure a deferred tax liability or asset?

- A. 15%
- B. 25%
- C. 27.5%
- D. 35%

**Answer: C**

In measuring a deferred tax liability (DTL) or asset (DTA), the objective is to use the enacted or substantively enacted tax rate(s) expected to apply to taxable profit in the periods in which the deferred tax liability or asset is expected to be settled or realized. If different rates apply to different taxable profit levels, a DTA or DTL is measured based on the average rates expected to apply in the periods when the TDs are expected to reverse. Accordingly, the applicable tax rate is 27.5%.

<u>Taxable Profit</u>		<u>Tax Rate</u>		
US \$ 50,000	×	15%	=	US \$ 7,500
50,000	×	25%	=	12,500
100,000	×	35%	=	35,000
<u>US \$200,000</u>				<u>US \$55,000</u>
$\text{US \$55,000} \div \text{\$200,000} = 27.5\%$				

**QUESTION: 199**

When an entity reports deferred tax assets and liabilities, deferred tax expense or income reflects

- A. A change in deferred tax assets.
- B. The changes in deferred tax assets and deferred tax liabilities.
- C. A change in deferred tax liabilities.
- D. Amount of the total tax liability.

**Answer: B**

Deferred tax expense or income is the sum of the changes in the deferred tax assets and deferred tax liabilities. For example, this amount reflects changes relating to the

origination or reversal of temporary differences, changes in tax rates. and imposition of new taxes.

**QUESTION: 200**

On December 31, Year 1, Health entities reported a US \$150,000 warranty expense in its income statement. The expense was based on actual warranty cost of US\$30,000 in Year 1 and expected warrant costs of US \$35,000 in Year 2, US \$40,000 in Year 3, and US \$45,000 in Year 4. For tax purposes, warrant costs are not deductible until paid. At December 31, Year 1, deferred taxes should be based on a

- A. US \$ 120,000 deductible temporary difference.
- B. US \$ 150,000 deductible temporary difference.
- C. US \$ 120,000 taxable temporary difference.
- D. US \$ 150,000 taxable temporary difference.

**Answer: A**

At year-end year 1, Health entities should report a US \$120,000 warranty liability in its balance sheet. The warranty liability is equal to the US \$150,000 warranty expense minus the US \$30,000 warrant cost actually incurred in Year 1. Because warranty costs are not deductible until paid, the tax base of the warranty liability is 0. The result is a US \$120,000 temporary difference (US \$120,000 carrying amount tax base). When the liability is settled through the actual incurrence of warranty costs, the amounts will be deductible. Thus, the temporary difference should be classified as a deductible temporary difference.

**QUESTION: 201**

How do temporary and permanent differences between taxable income and pre-tax financial income differ?

- A Temporary differences do not give rise to future taxable or deductible amounts.
- B Only permanent differences have deferred tax consequences
- C Only temporary differences have deferred tax consequences
- D. Temporary differences include items that enter into pre-tax financial income but never into taxable income.

**Answer: C**

Permanent differences have no deferred tax consequences because they affect only the period in which they occur. Permanent differences include 1) items that enter into pre-tax financial income but never into taxable income and 2) items that enter into taxable income but never into pre-tax financial income. In contrast, temporary differences result in

taxable or deductible amounts in some future year(s), when the reported amount of assets are recovered and the reported amount of liabilities are settled. Temporary differences therefore do have deferred tax consequences while permanent differences do not.

**QUESTION: 202**

Company M, which began operations on January 1, Year 1, recognizes income from long-term construction contracts under the percentage-of-completion method in its financial statements and under the completed-contract method for tax reporting. Income under each method follows:

<u>Year</u>	<u>Completed- Contract</u>	<u>Percentage- of-Completion</u>
Year 1	--	US \$300,000
Year 2	US \$400,000	600,000
Year 3	700,000	850,000

There are no other temporary differences. If the applicable tax rate is 25%, what amount should Company M report in its balance sheet at December 31, Year 3, for deferred income tax liability?

- A. US \$87,500
- B. US \$125,000
- C. US \$162,500
- D. US \$37,500

**Answer: C**

In its financial statements issued through December 31, Year 3, Company M has reported US \$1,750,000 (\$300,000 + \$600,000 + \$850,000) of income from long-term contracts. In its tax returns for the same period, it has reported US \$1,100,000 (\$400,000 + \$700,000) of income from the same sources. The result is a taxable temporary difference. Thus, Company M expects to have future taxable amounts of US \$650,000 and should recognize a deferred tax liability of US \$162,500 (\$650,000 x 25% applicable tax rate).

**QUESTION: 203**

A deferred tax asset is recognized for

- A Goodwill if its amortization is nondeductible for tax purposes.
- B The initial recognition of an asset that is not part of a business combination and does not affect accounting profit or taxable profit at the date of the transaction.
- C A deductible temporary difference if the future availability of taxable profit is probable
- D Negative goodwill treated as deferred income.



**Answer: C**

A deferred tax asset is recognized for most deductible TDs and for the carryforward of unused tax losses and credits, but only to the extent it is probable that taxable profit will be available to permit the use of those amounts.

**QUESTION: 204**

At the beginning of Year 1, a company began work on a 3-year construction contract. This contract is accounted for by the percentage-of-completion method for financial accounting purposes and the completed-contract method for tax purposes. During Year 1, the company reported US \$800,000 of income from this contract. However, because of cost overruns incurred in Year 2, the company reported a US \$500,000 loss from this contract. What should the company's Year 2 balance sheet include?

	Deferred Tax Asset	Deferred Tax Liability
A.	Yes	Yes
B.	Yes	No
C.	No	No
D.	No	Yes

**Answer: D**

A deferred tax liability is recognized for the deferred tax consequences attributable to most taxable temporary differences. A deferred tax asset is recognized for the deferred tax consequences attributable to most deductible temporary differences, but only to the extent it is probable that taxable profit will be available to permit the use of those amounts. At the end of Year 2, the cumulative effect of the difference in accounting for financial reporting and tax purposes is a US \$300,000 (\$800,000 – \$500,000) temporary difference. Because this US \$300,000 temporary difference will result in future taxable amounts, it is a taxable temporary difference for which a deferred tax liability is recognized.

The following relates to PLC for Year 1 and Year 2.

	Year 2	Year 1
Profit before income taxes	US \$5,000,000	US \$4,000,000
Interest income included above that was not subject to income taxes	100,000	100,000

- Profit before income taxes in Year 1 included rent income of US \$80,000 that was not subject to income tax until its receipt in Year 2.
- Lally was subject to an effective income tax rate of 40% in Year 1 and Year 2.

**QUESTION: 205**

What is the tax expense that would have been reported on Lally's income statement for the year ended December 31, Year 1?

- A. US \$1,560,000
- B. US \$1,528,000
- C. US \$1,600,000
- D. US \$1,568,000

**Answer: A**

Tax expense (tax income) equals the sum of current tax expense (current tax income) and deferred tax expense (deferred tax income). Current tax expense equals taxes paid or payable, and deferred tax expense equals the change in the entity's deferred tax assets and liabilities. Because US \$100,000 of interest income and US \$80,000 of rental income are not subject to tax in Year 1, taxable profit is US \$3,820,000, and current tax expense is US \$1,528,000. Deferred tax expense equals the deferred tax liability (US \$11,000  $\times$  40% = US \$32,000) at year end, assuming no deferred tax asset or liability balances existed at the beginning of the year. Hence tax expense is US \$1,560,000 (US \$1,528,000 + US \$32,000).

The following relates to Lally PLC for Year 1 and Year 2.

	Year 2	Year 1
Profit before income taxes	US \$5,000,000	US \$4,000,000
Interest income included above that was not subject to income taxes	100,000	100,000

Profit before income taxes in Year 1 included rent income of US \$80,000 that was not subject to income tax until its receipt in Year 2.

Lally was subject to an effective income tax rate of 40% in Year 1 and Year 2.

**QUESTION: 206**

What is Lally's current tax expense for Year 2?

- A. US \$1,960,000
- B. US \$1,992,000
- C. US \$2,000,000
- D. US \$2,032,000

**Answer: B**

The US \$5,000,000 of pre-tax profit is reduced by the US \$100,000 of interest income not subject to tax. However, the rental income accrued in the previous year is taxable in Year 2. Thus, the profit subject to tax is US \$4,980,000. Given a 40% rate, the current tax expense is US \$1,992,000.

The following relates to Lally PLC for Year 1 and Year 2.

Year 2 Year 1

Profit before income taxes US \$5,000,000 US \$4,000,000

Interest income included above that was not  
subject to income taxes 100,000 100,000

- Profit before income taxes in Year I included rent income of US \$80,000 that was not subject to income tax until its receipt in Year 2\_
- Lally was subject to an effective income tax rate of 40% in Year 1 and Year 2.

**QUESTION: 207**

What is the deferred tax asset or liability reported on Lally's balance sheet on December 31, Year 2?

- A. US \$40,000
- B. US \$32,000
- C. US \$8,000
- D. US \$0

**Answer: D**

Deferred tax assets arise from deductible temporary differences and the carryForward of unused tax losses and credits. Deferred tax liabilities arise from taxable temporary differences. The interest income not subject to tax resulted in neither future taxable nor future deductible amounts and therefore no deferred tax item was recognized for it. The only item resulting in a temporary difference was the rental income. A deferred tax liability would have been created at the end of Year I \_ Given that the difference reversed in Year 2, no deferred amount existed at the end of Year 2.

**QUESTION: 208**

A company uses straight-line depreciation for financial reporting purposes, but uses accelerated depreciation for tax purposes. Which of the following account balances would be lower in the financial statements used for tax purposes than it would be in the general purpose financial statements?

- A. Accumulated depreciation.
- B. Cash.
- C. Retained earnings.
- D. Gross fixed assets.

**Answer: C**

Under accelerated depreciation, depreciation expense is higher and net income is lower.

Retained earnings would then be lower for tax-reporting purposes than for general purpose financial reporting based on straight-line depreciation.

**QUESTION: 209**

On December 31, Year 1, XYZ issued 5-year bonds with a face amount of US \$1 million. The bonds carry a stated interest rate of 10% and were sold at par. Interest is payable annually on December 31. According to the provisions of the bond indenture, XYZ was to make annual deposits into a bond sinking fund (beginning December 31, Year 2) to accumulate the funds necessary to retire the bonds at their maturity. On December 31, Year 5, all required interest payments and sinking-fund payments due to date had been made on schedule. If the sinking-fund assets are properly classified as noncurrent. How should the balance of bonds payable be classified on the December 31, Year 5 balance sheet?

- A. Current liability
- B. Long-term liability.
- C. Contra to long-term investments.
- D. Deferred credit.

**Answer: A**

A current liability is an obligation that is expected to be settled within the normal operating cycle or is due to be settled within 12 months of the balance sheet date. Any other liability is noncurrent. Some current liabilities are included in the working capital employed in the normal operating e.g., trade payables and accrued employee operating costs. Current liabilities not settled within the normal operating cycle include the current part of interest-bearing debt, dividends, income taxes, and bank overdrafts. Thus, the bonds payable should be classified as current because they are due to be settled within 12 months. Under the Standards, the classification of the sinking-fund assets is irrelevant to the classification of the bond payable.

**QUESTION: 210**

At December 31, Year 2, an entity had the following obligations that were expected to be refinanced:

17% note payable	US \$140,000
15% note payable	US \$200,000

The 17% note payable was issued on October 1, Year 1, and matures on July 1, Year 3. No loan agreement existing at the balance sheet date provides for refinancing. The 15% note payable was issued on May 1, Year 1, and matures on May 1, Year 3. On February 1, Year 3, the entire US \$140,000 balance of the 17% note payable was refinanced by issuance of a long-term debt instrument. On February 7, Year 3, the entity entered into a

noncancelable agreement with a lender to refinance the 15% note payable on a long-term basis. The financial statements were authorized to be issued on March 1, Year 3. The total amount of obligations that may be properly excluded from current liabilities on the entity's December 31, Year 2, balance sheet is

- A. US \$0
- B. US \$140,000
- C. US \$200,000
- D. US \$340,000

**Answer: A**

Financial liabilities are current if they are due within 12 months even if 1) the original term was for more than 12 months and 2) an agreement to refinance on a long-term basis was completed after the balance sheet and before the issuance of the financial statements. Thus, both notes are current. The amount excluded from current liabilities is US \$0.

**QUESTION: 211**

On August 1, Year 1, an entity issued 5-year bonds with a face amount of US \$10 million. The bonds carry a stated interest rate of 11% and interest is payable annually on July 31. Which is the appropriate classification of bonds payable and the related accrued interest payable on the December 31, Year 5, balance sheet?

Classification Table		
	<u>Bonds Payable</u>	<u>Interest Payable</u>
Classification A	Current liability	Current liability
Classification B	Current liability	Long-term liability
Classification C	Long-term liability	Current liability
Classification D	Long-term liability	Long-term liability

- A. Classification A.
- B. Classification B.
- C. Classification C.
- D. Classification D.

**Answer: A**

A current liability is an obligation that is expected to be settled within the normal operating cycle or is due to be settled within 12 months of the balance sheet date. Any other liability is noncurrent. Some current liabilities are included in the working capital employed in the normal operation cycle, e.g., trade payables and accrued employee operating costs. Current liabilities not settled within the normal operating cycle include the current part of interest-bearing debt, dividends, income taxes, and bank overdrafts. Given that the bonds payable and interest payable are due within 12 months, they should

be classified and current.

**QUESTION: 212**

At its balance sheet date, an entity reliably estimates that the expected cost of compensated absences resulting from short-term disability will be US \$100,000. This unused entitlement arose from employee services rendered during the period and is accumulating. How should it be accounted for?

- A. Only a disclosure should be made because recognition does not occur until the absences occur.
- B. An expense should be recorded for US \$100,000.
- C. An asset of US \$100,000 should be recognized.
- D. A direct reduction to retained earnings of US \$100,000 should occur.

**Answer: B**

Short-term employee benefits expected to be paid as a result of service rendered during the period ordinarily should be recognized as an expense and a liability (accrued expense). For short-term compensated absences, the timing of recognition depends on whether the benefits accumulate. If the benefits for compensated absences accumulate, the expected cost of short-term compensated absences is recognized when services are rendered that increase the employees' entitlement to future compensated absences. The obligation is recognized whether it is vesting (the employee is entitled to a cash payment for an unused entitlement upon leaving the entity) or not vesting. The amount should not be discounted. It equals the additional amount expected to be paid as a result of the unused accumulated entitlement at the balance sheet date. Hence, the entity should debit expense and credit liability for US \$100,000 because the entitlement accumulates and the employees have rendered services during the period that increase their future entitlement.

**QUESTION: 213**

An entity allows customers to redeem 20 coupons for a toy (cost US \$3.00). Estimates are that 40% of coupons distributed will result in redemption. Since beginning the promotion this year, 4 million coupons were distributed and 1 million coupons redeemed. The adjusting entry to accrue for unredeemed coupons at year-end is

A. Premium expense	US \$90,000	
Provision for premiums		US \$90,000
B. Sales	US \$90,000	
Provision for premiums		US \$90,000
C. Premium expense	US \$1,800,000	
Provision for premiums		US \$1,800,000
D. Sales	US \$1,800,000	
Provision for premiums		US \$1,800,000

**Answer: A**

An expense and a provision should be accrued for the coupons still outstanding that are expected to be redeemed. Of the 4 million coupons distributed, 411%, or 1.6 million, are estimated to be redeemable. Of those, 1 million have already been redeemed, and 600,000 more are expected to be redeemed. The promotion requires 20 coupons to receive one toy, so,  $30,000(600,000 \div 20)$  more toys will be required. Each toy costs US \$3.00, creating a provision of US \$90,000  $(30,000 \times \$3.00)$ .

**QUESTION: 214**

The publisher of a popular magazine offers a special discounted price for a 3-year subscription. At the balance sheet date, the amount that has already been collected but pertains to future periods is best referred to as

- A. Accrued subscriptions revenue (an asset account).
- B. Deferred subscriptions revenue (a liability account).
- C. Earned subscriptions revenue (a revenue account).
- D. Precollected subscriptions receivable (a deferred asset account).

**Answer: B**

Income, which includes revenue and gains, is recognized in the income statement when an increase in future economic benefits related to an increase in an asset or a decrease in a liability can be reliably measured. Revenue is recognized (reported as revenue) in the period in which the recognition criteria are met; therefore, when it is received in advance, the amount applicable to future periods is deferred. This deferral reflects the uncertainty of the reliable measurement of the future economic benefits. The uncertainty arises because the entity still must satisfy an obligation to perform in the future before it is entitled to the future economic benefits. The amount received in advance is considered a liability because it represents a present obligation arising from a past event. Accordingly, deferred or unearned revenue is an amount that has been received but that has not met the recognition criteria for revenue.

**QUESTION: 215**

A cable television entity receives deposits from customers that are refunded when service is terminated. The average customer stays with the entity 8 years. How should these deposits be shown on the financial statements?

- A. Operating revenue.
- B. Other revenue.
- C. Share capital.
- D. Liability.

**Answer: D**

Liabilities are present obligations arising from past events, the settlement of which is expected to result in an outflow of resources embodying economic benefits. Customers' deposits must be returned or credited to their accounts. The deposits should therefore be recorded as liabilities.

**QUESTION: 216**

In performing an audit, you encounter an adjusting journal entry recorded at year-end that contains a debit to rental revenue and a credit to deferred rental revenue. The purpose of this journal entry is to record

- A An accrued revenue.
- B. An unexpired expense.
- C. An expired expense.
- D. A liability.

**Answer: D**

A deferred revenue is a revenue item that has been received but has not met the recognition criteria. The journal entry described in the question is an adjusting entry to transfer an amount from the revenue account to a liability (deferred revenue) account. The initial collection of cash in advance from the tenant was apparently recorded by a credit to revenue. An adjusting entry is therefore required at year-end to transfer any remaining amount that does not qualify for revenue recognition.

**QUESTION: 217**

Suppose that an entity has paid one of its liabilities twice during the year, in error. The effects of this mistake would be

- A Assets, liabilities, and equity are understated.
- B Assets, net income, and equity are unaffected
- C Assets and liabilities are understated.
- D. Assets and profit and equity } are understated, and liabilities are overstated.

**Answer: C**

When a liability is paid, an entry debiting accounts payable and crediting cash is made. If an entity erroneously pays a liability twice, the accounts payable and cash accounts will be understated by the amount of the liability. Hence, assets and liabilities will be understated.



**QUESTION: 218**

The proper classification of noncurrent obligations scheduled to mature within 12 months of the balance sheet date but that are expected to be refinanced on a long-term basis should be to

- A. Exclude all such obligations from the current liabilities classification.
- B. Include in the current liabilities classification those obligations that have actually been refinanced on a long-term basis after the balance sheet date but before the financial statements are authorized to be issued.
- C. Exclude from the current liabilities classification those obligations that have been refinanced on a long-term basis after the balance sheet date but before the financial statements are authorized to be issued.
- D. Exclude from the current liabilities classification those obligations management wishes to exclude because they intended to convert them to long-term obligations.

**Answer: B**

A liability is classified as current if 1) it is expected to be settled with the normal operating cycle of the entity, 2) it is held primarily for trading, 3) it is due within 12 months of the balance sheet date, and 4) the entity has no unconditional right to defer payment for at least 12 months after the balance sheet date. All other liabilities are noncurrent. (1)

**QUESTION: 219**

An entity introduced a new product that carries a 2-year warranty against defects. It estimates that warranty costs will be 2% of sales in the year of sale and 3% of sales in the year following the year of sale. Sales in Year 1 and Year 2 were US \$5 million and US \$7 million, respectively. Actual costs of servicing the warranty in Year 1 and Year 2 were US \$110,000 and US \$260,000, respectively. What provision for warranty costs must the entity record in Year 2?

- A. US \$260,000
- B. US \$290,000
- C. US \$350,000
- D. US \$370,000

**Answer: C**

The warranty provision must be matched with revenue in the year of sale. Thus, the provision related to Year 2 sales must be recognized in Year 2 even if actual expenditures will not occur until Year 3. The provision related to Year 2 sales equals US \$350,000 [\$7,000,000 × 2% for the year of sale + 3% for the year after the year of sale].

**QUESTION: 220**

A manufacturer produces a quality product for which it charges a little more than some competing items but gives its consumers a more liberal warranty policy. The product carries a 5-year warranty that covers both labor and materials charges. Which of the following defines the appropriate method of accounting for the warranty?

- A. Cash basis
- B. Recognition of a provision.
- C. Sales warranty.
- D. Tax basis.

**Answer: B**

A provision is a liability of uncertain timing and amount. A liability is a present obligation arising from past events, the settlement of which is expected to result in an outflow of resources embodying economic benefits. Whether a past event results in a present obligation is usually clear. Thus, it is clear from the circumstances that the entity's sale of goods without warranty is an obligating event that resulted in a present obligation for the issuance of warranty costs. Recognition of provisions is appropriate when the entity has a legal or constructive present obligation resulting from a past event (called an obligating event), it is probable that an outflow of economic benefits will be necessary to settle the obligation, and its amount can be reliably estimated. Assuming that the amount of warranty costs can be reliably estimated although they are uncertain in timing and amount compared with a trade payable, for example) and that the outflow is probable in these circumstances, "more likely than not"), the manufacturer's contractual present obligation should result in recognition of a provision.

**QUESTION: 221**

Because of a defect discovered in its seat belts in December Year 1, an automobile manufacturer believes it is probable that it will be required to recall its products. The final decision on the recall is expected to be made in March Year 2. The cost of the recall is reliably estimated to be US \$2.5 million. How should this information be reported in the December 31, Year 1, financial statements?

- A. As a loss of US \$2.5 million and a provision of US \$2.5 million.
- B. As an adjustment of the opening balance of retained earnings equal to US \$25 million
- C. As an appropriation of retained earnings of US \$25 million.
- D. It should not be disclosed because it has not yet happened.

**Answer: A**

A provision is a liability of uncertain timing or amount. Recognition of provisions is appropriate when the entity has a legal or constructive present obligation resulting from a past event (called an obligating event), it is probable that an outflow of economic benefits will be necessary to settle the obligation, and its amount can be reliably estimated. Consequently, the company must recognize a loss and a liability for US \$2.5 million.

**QUESTION: 222**

An entity is subject to warranty claims. A reliable estimate is that between US \$1 million and US \$3 million will probably be paid out. No estimate of loss within this range is more likely than any other. The entity should

- A. Make no journal entry at this time.
- B. Disclose only a possible loss.
- C. Defer a provision of US \$1 million to US \$3 million depending on the applicable national accounting standards.
- D. Recognize a provision of US \$1 million to US \$3 million depending on the applicable national accounting standards.

**Answer: D**

A provision is a liability of uncertain timing or amount. Recognition of provisions is appropriate when the entity has a legal or constructive present obligation results from a past event (called an obligating event), it is probable that an outflow of economic benefits will be necessary to settle the obligation, and its amount can be reliably estimated. Thus, a provision should be recognized. Moreover, the amount recognized should be the best estimate of the expenditure required to settle the obligation. However, the amount within the reliable estimate of the range of the obligation that will be recognized will vary from country to country.

**QUESTION: 223**

Which one of the following will usually be accounted for by recognizing a provision?

- A. Just prior to the balance sheet date, the board decided to close a division. No implementation steps have been taken.
- B. As of the balance sheet date, the board was aware that a new law would require the entity to fit smoke filters to its factories within the next year. No such filters have been fitted.
- C. A law requires an airline to overhaul its aircraft once every 3 years.
- D. Premiums offered to customers.

**Answer: D**

When premiums are offered to customers, for example, upon redemption of coupons the entity can usually establish that it has a legal present obligation resulting from a past event and that an outflow of economic benefits is probable. Furthermore, if the entity has prior experience with such offers or information about the experience of similar entities, a reliable estimate of the obligation should be feasible. If no obligating event has occurred, the entity could avoid the future expenditure by its future actions.

**QUESTION: 224**

Which of the following is not a factor, with respect to pending litigation, that must be considered in determining whether a provision should be recognized?

- A. The time period in which the underlying cause of action occurred.
- B. The probability of an unfavorable outcome.
- C. The ability to make a reliable estimate of the amount of loss.
- D. The number of parties involved in the litigation.

**Answer: D**

The number of parties involved in the litigation is irrelevant. For example, the same accounting treatment is applied whether a claim is brought by an individual or in a class action suit.

**QUESTION: 225**

An entity has been sued for US \$100 million for producing and selling an unsafe product. Attorneys for the entity cannot reliably predict the outcome of the litigation. In its financial statements, the entity should

- A. Make the following journal entry, and disclose the existence of the lawsuit in a note.  
Estimated loss from litigation US \$100,000,000    Estimated provision for litigation loss US \$100,000,000
- B. Disclose the existence of the lawsuit in a note without making a journal entry.
- C. Neither make a journal entry nor disclose the lawsuits in a note because bad publicity will hurt the entity.
- D. Make the following journal entry, and disclose the existence of the lawsuit in a note.  
Cost of goods sold US \$100,000,000    Estimated provision for litigation loss US \$100,000,000

**Answer: B**

In the very rare case in which a reliable estimate of an obligation that otherwise qualifies for treatment as a provision cannot be determined, no liability is recognized. Instead, the existing liability is disclosed as a contingent liability unless the possibility of any outflow

in settlement is remote).

**QUESTION: 226**

An entity is currently being sued by a customer. A reliable estimate can be made of the costs that would result from a ruling unfavorable to the entity, and the amount involved is material. The entity's managers, lawyers, and auditors agree that the likelihood of an unfavorable ruling is remote. This contingent liability

- A. Should be disclosed in a note.
- B. Should be disclosed as a parenthetical comment in the balance sheet.
- C. Need not be disclosed.
- D. Should be disclosed by an appropriation of retained earnings.

**Answer: C**

A contingent liability includes a present obligation for which an outflow of resources embodying economic benefits is not probable. A contingent liability is not recognized but is disclosed unless the possibility of the outflow is remote.

**QUESTION: 227**

Which of the following is an example of a contingent liability?

- A. A retail store in a shopping mall pays the lessor a minimum monthly rent plus an agreed-upon percentage of sales.
- B. A company is refusing to pay the invoice for the annual audit because it seems higher than the amount agreed upon with the public accounting entity's partner .
- C. A company accrues income tax payable in its interim financial statements.
- D. A lessee agrees to reimburse a lessor for a shortfall in the residual value of an asset under lease

**Answer: D**

This is a guarantee. The liability is contingent on the lessor's not receiving the full residual value from a third party.

**QUESTION: 228**

At December 31 of Year 1, an entity had a provision of US \$40,000 for the "Estimated Liability under Warranties" account. During Year 2, the entity sold 1,000 new units under warranties reliably estimated at US \$100 per unit. The actual parts and labor warranty expenditures for Year 2 were US \$90,000. Warranty expense for Year 2 should be

- A. US \$40,000
- B. US \$50,000
- C. US \$90,000
- D. US \$100,000

**Answer:** D

Recognition of provisions is appropriate when the entity has a legal or constructive present obligation resulting from a past event (called an obligating event), it is probable that an outflow of economic benefits will be necessary to settle the obligation, and its amount can be reliably estimated. Accordingly, a provision should be recognized for warranty expense in the period in which the matching revenue is recorded. Thus, the debit to warranty expense and the credit to provision for warranty expense in Year 2 is US \$100,000 (1,000 units x \$100).

**QUESTION:** 229

Which of the following is required in order for an entity to record a provision?

- A The exact payee must be known.
- B The exact date payable must be known.
- C. It must be reasonably possible that an outflow of resources will be required to settle the obligation.
- D. It must be possible to determine a reliable estimate of the amount of the obligation.

**Answer:** D

A provision is a liability of uncertain timing and amount. Recognition of provisions is appropriate when the entity has a legal or constructive present obligation (from a past event called an obligating event), it is probable that an outflow of economic benefits will be necessary to settle the obligation, and its amount can be reliably estimated.

**QUESTION:** 230

An entity has the following contingencies at a balance sheet date:

- I. An obligation for clean-up costs relating to environmental damage may, but probably will not, require an outflow of resources.
- II. An obligation for decommissioning costs of a nuclear reactor may, but probably will not, require an outflow of resources.
- III. The entity is jointly and severally liable for an obligation arising from a lawsuit: the likelihood of an outflow of resources is remote.

Which of the above items must be disclosed in the notes to the financial statements?

- A. I and II only.
- B. II and III only.
- C. I and III only.
- D. I, II, and III.

**Answer: A**

Recognition of provisions is appropriate when the entity has a legal or constructive present obligation resulting from a past event (called an obligating event), it is probable that an outflow of economic benefits will be necessary to settle the obligation, and its amount can be reliably estimated. Thus, none of the circumstances in the question meet the recognition criteria for a provision. Hence, each is treated as a contingent liability, which requires disclosure unless the possibility of the outflow of resources is remote.

**QUESTION: 231**

In Year 1, Company C introduced a new line of computer products that carry a 2-year warranty against defects and workmanship. The entity estimates that the total warranty cost will be 10% of sales, with 40% of the expenditures occurring during the first year and 60% during the second year. Sales and actual warranty expenditures for Year 1 and Year 2 were as follows:

Year	Sales	Actual Warranty Expenditures
1	US \$300,000	US \$12,000
2	400,000	30,000

At the end of Year 2, what will the balance in the estimated accrued warranty liability account be?

- A. US \$24,000
- B. US \$46,000
- C. US \$58,000
- D. US \$28,000

**Answer: D**

If the warranty expense is 10% of sales, the total expense for the 2 years is US \$70,000 (\$700,000 × 10%). Of that US \$70,000, \$12,000 was paid in Year 1 and \$30,000 in Year 2. The US \$42,000 of payments leaves an unpaid balance of US \$28,000 (\$70,000 – \$42,000).

**QUESTION: 232**

The unit selling price of a new entity's product is US \$10,000. The buyers are provided with a 2-year warranty that is expected to cost the entity US \$250 per unit in the year of

the sale and US \$750 per unit in the year following the sale. The entity sold 80 units in the first year of operation and 100 units in the second year. Actual payments for warranty claims were US \$10,000 and US \$65,000 in years one and two, respectively. The amount charged to warranty expense during the second year of operation is

- A. US \$25,000
- B. US \$65,000
- C. US \$85,000
- D. US \$100,000

**Answer:** D

Under the accrual method, the total estimated warranty costs are charged to operating expense in the year of sale. The total estimated warranty cost per unit is US \$1,000 (\$250 + \$750). In year two, 100 units were sold, so the warranty expense recognized is US \$100,000.

**QUESTION:** 233

A contingent asset is

- A. Recognized when condemnation awards are probable or can be reliably estimated.
- B. Recognized when damages to be awarded in a copyright infringement suit are highly probable.
- C. Recognized when disclosure in the notes to financial statements only could be misleading.
- D. Not recognized under any circumstances.

**Answer:** D

A contingent asset is a possible asset arising from past asset and the existence of which will be confirmed only by uncertain future events not wholly within the entity's control. An example is a potential recovery on a legal claim with an uncertain outcome. A contingent asset is not recognized but should be disclosed if an inflow of economic benefits is probable. Disclosures include a description of the contingent asset and an estimate of its financial effects. A contingent asset is not recognized because the income may not be realized. However, if realization is virtually certain, the asset is not contingent and may be recognized.

**QUESTION:** 234

If bonds are initially sold at a discount and the effective-interest method of amortization is used,



- A Interest expense in the earlier periods will be less than interest expense in the later periods.
- B Interest expense in the earlier periods will be greater than interest expense in the later periods.
- C. Interest expense will equal the cash interest payment each period.
- D. Interest expense will be less than the cash interest payment each period.

**Answer: A**

Interest expense equals the carrying amount of the liability at the beginning of the period times the effective interest rate. The carrying amount of the liability equals the face amount of the bond minus the discount. As the discount is amortized over the life of the bond, the carrying amount increases. Consequently, the interest expense increases over the term of the bond.

**QUESTION: 235**

An entity issues 10-year bonds with a face amount of US \$1 million, dated January 1, Year 1, and bearing interest at an annual rate of 12% payable semiannually on January 1 and July 1. The full interest amount will be paid each due date. The market rate of interest on bonds of similar risk and maturity, with the same schedule of interest payments, is also 12%. If the bonds are issued on February 1, Year 1, the amount the issuing entity receives from the buyers of the bonds on that date is

- A. US \$990,000
- B. US \$1,000,000
- C. US \$1,010,000
- D. US \$1,020,000

**Answer: C**

The amount the issuing entity receives on 2/1/1Yr 1 is the face amount of the issue plus 1 month of accrued interest, or US \$1,010,000  $\{ \$1,000,000 + [(\$1,000,000 \times 12\%) - 12] \}$ .

**QUESTION: 236**

How will profit or loss be affected by the amortization of a premium on bonds payable?

- A. Interest expense is decreased, so profit or loss is increased
- B. Interest expense is increased, so profit or loss is decreased
- C. Interest income is increased, so profit or loss is increased.
- D Interest income is decreased, so profit or loss is decreased.

**Answer: A**

The entry is to debit interest expense, debit bond premium, and credit cash paid. Thus, the amortization of a premium on bonds payable reduces the interest expense, thereby increasing profit or loss

**QUESTION: 237**

On May 1, Year 1, an entity issued, at 103 plus accrued interest, 500 of its 12%, US \$1,000 bonds. The bonds are dated January 1, Year 1, and mature on January 1, Year 6. Interest is payable semiannually on January 1 and July 1. The journal entry to record the issuance of the bonds and the receipt of the cash proceeds is

A. Cash	US \$515,000	
Interest payable	20,000	
Bonds payable		US \$500,000
Premium on bonds payable		35,000
B. Cash	US \$525,000	
Bonds payable		US \$500,000
Premium on bonds payable		15,000
Interest payable		10,000
C. Cash	US \$535,000	
Bonds payable		US \$500,000
Premium on bonds payable		15,000
Interest payable		20,000
D. Cash	US \$535,000	
Bonds payable		US \$500,000
Premium on bonds payable		35,000

**Answer: C**

The face amount of the 500 bonds is equal to US \$500,000 (500 x \$1,000). The cash proceeds excluding interest from the issuance of the bonds are US \$515,000 (\$500,000 x 103%). The US \$15,000 premium is the difference between the cash issuance proceeds and the face amount of the bonds. Because the bonds were issued between interest payment dates, the issuer is also entitled to receive accrued interest for the 4 months between the prior interest date and the issuance date. The accrued interest is US \$20,000 [500 bonds x \$1,000 face value x 12% stated rate x 4/12]. The issuing entity will therefore receive US \$535,000 in cash (\$515,000 + \$20,000). The resulting journal entry includes a US \$535,000 debit to cash, a US \$500,000 credit to bonds payable, a US \$15,000 credit to premium, and a US \$20,000 credit to either interest payable or interest

**QUESTION: 238**

An entity issues bonds payable at a premium. You are analyzing the effects of using the effective interest rate (constant yield) method in accounting for the bonds over their 10-year life. Which of the following trends related to the reported amounts for 1) interest expense and 2) carrying amount of the bonds would you expect to find?

	<u>Interest Expense</u>	<u>Carrying Amount</u>
A.	Constant amount	Constant amount
B.	Increasing amount	Decreasing amount
C.	Decreasing amount	Decreasing amount
D.	Decreasing amount	Constant amount

**Answer: C**

When the effective interest rate method is used, interest expense equals the effective rate (a constant rate) times the carrying amount at the beginning of the period. The carrying amount is the par value plus the balance of the unamortized premium. The difference between interest expense and the nominal interest is the premium amortization for the period. Thus, interest expense is a decreasing amount each period because a constant rate is applied to a decreasing carrying amount.

**QUESTION: 239**

The effective-interest method and the straight-line method of amortizing a bond discount differ in that the effective-interest method results in

- A. Higher total interest expense over the term of the bonds.
- B. Escalating annual interest expense over the term of the bonds.
- C. Shrinking annual interest expense over the term of the bonds.
- D. Constant annual interest expense over the term of the bonds.

**Answer: B**

Under the effective-interest method, interest expense for each period equals the effective interest rate times the carrying value of the bond issue. As the discount is amortized, the carrying value rises and interest expense increases.

**QUESTION: 240**

On January 1, an entity issued a 10-year US \$500,000 bond at 96% of its face amount. The bond bears interest at 12%, payable on January 1 and July 1. The entry to record the issuance of the bond on January 1 is

A. Cash	US \$480,000	
Bonds payable		US \$480,000
B. Cash	US \$500,000	
Bonds payable		US \$500,000
C. Cash	US \$480,000	
Discount on bonds payable	20,000	
Bonds payable		US \$500,000
D. Cash	US \$500,000	
Premium on bonds payable		US \$20,000
Bonds payable		480,000

**Answer: C**

The entity received US \$480,000 cash on the issuance of the bond. Its face amount is US \$500,000, the amount to be paid at maturity. Hence, the credit to bonds payable is US \$500,000. The US \$20,000 difference is recorded as a discount on bonds payable (debit) and is amortized over the life of the issue.

**QUESTION: 241**

Compared with another bond with the same risk and maturity but without a conversion feature, a convertible bond has a

- A. Higher face amount.
- B. Lower face amount.
- C. Higher coupon rate.
- D. Lower coupon rate.

**Answer: D**

Convertible bonds are convertible at the holder's option into the issuer's ordinary shares at a specified price. They have a lower coupon rate than nonconvertible bonds because they offer investors a chance for capital gains.

**QUESTION: 242**

On the first day of the current fiscal year, an entity issued 1,000 bonds, each of which is convertible into 199 ordinary shares of the issuer. The face amount of each bond is US \$1,000. the nominal annual interest rates: i 7%. and the market annual interest rate for similar nonconvertible debt is 9%. Interest is payable at the end of each year of the bonds' 5-year term. The present values of 1 for 5 periods at 7% and 9% are .713 and respectively. The present values of an ordinary annuity of 1 for 5 periods at 7% and 9% are 4.100 and respectively. The fair value of the bonds' equity component is not determinable. What is the entry for the recognition of the convertible bonds?

A. Cash	US \$1,000,000	
Bonds payable		US \$1,000,000
B. Cash	US \$1,000,000	
Bond discount	77,700	
Bonds payable		US \$1,000,000
Share capital-equity component of convertible debt		77,700
C. Cash	US \$1,000,000	
Bonds payable		US \$713,000
Share capital-equity component of convertible debt		287,000
D. Cash	US \$713,000	
Bond discount	287,000	
Bonds payable		US \$1,000,000

**Answer: B**

The initial total carrying amount of convertible debt or of debt instruments issued with

detachable share purchase warrants should be allocated between the debt instruments and the equity feature, and these debt and equity components should be separately accounted for. The total assigned initially to the instrument as a whole equals the fair value of the consideration received. However, the IFRSs do not stipulate a method for making the allocation. One approach is to assign to the less easily measurable component a residual amount after determining the amount of the more readily measurable component. For example, the future payments on the financial liability might be discounted at the market rate for a similar instrument without an equity feature. This amount would then be subtracted from the amount of the compound instrument as whole to determine the carrying amount of the equity feature. This method is appropriate when the fair value of the equity feature is not determinable. Thus, the present value of the principal repayment discounted at the market rate of 9% is US \$650,000 (\$1,000,000 / 1.0650), the present value of the interest payments discounted at 9% is US \$272,300 [(\$1,000,000 / 1.0650) × 0.09 × 3.890], and their total is US \$922,300. The residual amount assignable to the equity feature is therefore US \$77,700 [(1,000 bonds × \$1,000 par) proceeds - \$922,300 assigned to the debt component], which is also the bond discount given that the convertible bonds were issued at par.

**QUESTION: 243**

If bonds are sold at a discount and the effective interest method of amortization is used, interest expense will

- A. Increase from one period to another.
- B. Remain constant from one period to another.
- C. Equal the cash interest payment each period.
- D. Be less than the cash interest payment each period.

**Answer: A**

Interest expense equals the carrying value of the liability at the beginning of the period times the effective interest rate. The carrying value of the liability equals the face value of the of the bond minus the discount. As the discount is amortized over the life of the bond, the carrying value increases. Consequently, the interest expense increases over the life of the bond.

**QUESTION: 244**

During the year, an entity's balance sheet accounts increased by the following amounts:

Assets	US \$180,000
Liabilities	50,000
Ordinary shares	90,000
Share premium	15,000

Profit for the year was US \$42,000. The only other change in retained earnings was for

the declaration of cash dividends. The amount of dividends declared was

- A. US \$2,000
- B. US \$17,000
- C. US \$33,000
- D. US \$67,000

**Answer: B**

Assets equals liabilities plus equity. Given an increase of US \$180,000 in assets, the sum of liabilities plus equity must also have increased by US \$180,000. Because liabilities, share capital, and share premium increased by US \$155,000 + \$15,000) retained earnings must have increased by US \$25,000.  $\$180,000 - \$155,000 = \$25,000$ . Retained earnings must have been US \$17,000.  $\$42,000 - \$25,000 = \$17,000$ .

**QUESTION:245**

At December 31, Year 1, an entity had the following equity accounts:

Ordinary shares, US \$10 par, 100,000 shares authorized, 40,000 shares issued and outstanding	US \$ 400,000
Share premium from issuance of ordinary shares	640,000
Retained earnings	<u>1,000,000</u>
Total equity	<u><u>US \$2,040,000</u></u>

Each of the 40,000 ordinary shares outstanding was issued at a price of US \$26. On January 2, Year 2, 2,000 shares were reacquired for US \$30 per share. The cost method is used in accounting for these treasury shares. Which of the following correctly describes the effect of the acquisition of the treasury shares?

- A. Ordinary shares is reduced by US \$20,000.
- B. Share premium from issuance of ordinary shares is reduced by US \$32,000.
- C. The retained earnings account balance is reduced by US \$8,000.
- D. Total equity is reduced by US \$60,000.

**Answer: D**

Using the cost method, the journal entry to record the acquisition of the treasury shares includes a debit to treasury shares for US \$60,000. The balance of the treasury shares account is classified as a contra equity item. Thus, the acquisition of the treasury shares reduces total equity by US \$60,000.  $2,000 \text{ shares} \times \$30 = \$60,000$ .

**QUESTION: 246**

At December 31, Year 1, an entity has the following account balances:

Ordinary shares (US \$10 par, 50,000 shares issued)	US \$500,000
8% preference shares (US \$50 par, 10,000 shares issued)	500,000
Share premium on ordinary shares	640,000
Share premium on preference shares	20,000
Retained earnings	600,000

The preference shares are cumulative and nonparticipating and have a call price of US \$55 per share. The journal entry to record the redemption of all preference shares on January 2, Year 2, pursuant to the call provision is

A.	Preference shares	US \$500,000	
	Share premium: preference	20,000	
	Discount on preference shares		30,000
	Cash		US \$550,000
B.	Preference shares	US \$500,000	
	Share premium: preference	20,000	
	Loss on redemption of preference shares	30,000	
	Cash		US \$550,000
C.	Preference shares	US \$500,000	
	Loss on redemption of preference shares	50,000	
	Retained earnings	300,000	
	Cash		US \$550,000
	Share premium: preference		300,000
D.	Preference shares	US \$500,000	
	Share premium: preference	20,000	
	Retained earnings	30,000	
	Cash		US \$550,000

**Answer: D**

The exercise of the call provision resulted in the redemption of the 10,000 preference shares issued and outstanding at the call price of US \$55 (10,000 shares \$55 call price per share). To eliminate the carrying amount of the preference shares and recognize the cash paid in this transaction, the required journal entry is to debit preference shares for US \$500,000, debit share premium: preference for US \$20,000, and credit cash for US \$550,000. The difference of US \$30,000 (\$550,000 cash - \$520,000 carrying amount of the preference shares) is charged to equity (debit retained earnings). No loss is reported because the recognition of a gain or loss on transactions involving an entity's own shares is prohibited.

**QUESTION: 247**

Entity X effects self-insurance against loss from fire by appropriating an amount of retained earnings each year equal to the amount that would otherwise be paid out as fire insurance premiums. The procedure used by entity X

- A Prohibited for external reporting purposes.
- B. Acceptable provided that fire losses are not charged against the appropriation.
- C. Acceptable provided that fire losses are charged against the appropriation.
- D. Acceptable if the amount is shown outside the equity section of the balance sheet.

**Answer: B**

Accrual of an expense prior to the occurrence of the event for which an entity is self-insured should not be permitted. This rule holds because the fair value of the property diminishes only if the event actually occurs. But an appropriation of retained earnings is acceptable to disclose the self-insurance policy if when a fire loss occurs, the entry appropriating retained earnings is reversed and the loss is charged against income of period of loss and not against retained earnings.

**QUESTION: 248**

Unlike a share split, a share dividend requires a formal journal entry in the financial accounting records because share

- A. Dividends increase the relative carrying amount of an individual's share holding.
- B. Splits increase the relative carrying amount of an individual's share holdings.
- C. Dividends are payable on the date they are declared.
- D. Dividends represent a transfer from retained earnings to share capital.

**Answer: D**

The purpose of a share dividend is to provide evidence to the shareholders of their interest in accumulated earnings without distribution of cash or other property. Share dividends are typically accounted for by a transfer from retained earnings at fair value.

**QUESTION: 249**

Entity UK has 6,000 shares of 5% cumulative, US \$100 par value preference shares outstanding and 200,000 ordinary shares outstanding. The board of directors last declared dividends for the year ended May 31, Year 1, and there were no dividends in arrears. For the year ended May 31, Year 3, UK had profit of US \$1,750,000. The board of directors is declaring a dividend for ordinary shareholders equivalent to 20% of profit. The total amount of dividends to be paid by UK at May 31, Year 3, is

- A. US \$350,000
- B. US \$380,000
- C. US \$206,000
- D. US \$410,000



**Answer: D**

If an entity has cumulative preference shares, all preference dividends for the current and any unpaid prior years must be paid before any dividends can be paid on ordinary shares. The total preference dividends that must be paid equal US \$60,000 (6,000 share, X \$100 par 5% x 2 years). and the ordinary dividend is US \$350,000 (\$1,750,000 x 20%). for a total of US \$410,000.

**QUESTION: 250**

Early in its fiscal year, Starr purchased 1,000 shares of Pack ordinary shares for US \$54,000. In the same transaction, Starr acquired 2,000 detachable share purchase warrants. Two of the warrants are required to purchase one additional Pack ordinary share. The market price without the warrants was US \$49 per share. The market price of the warrants was US \$3.50 per warrant. Starr sold 50% of the warrants several weeks later. If the proceeds received by Starr equaled US \$4,000, it recognized a realized gain of

- A. US \$3,000
- B. US \$625
- C. US \$500
- D. US \$0

**Answer: B**

The recipient of share purchase warrants should allocate the carrying amount of the shares owned between those shares and the rights based on their relative fair values. Thus, the amounts to be allocated to the ordinary shares and warrants are US \$47,250  $\{(\$49 \times 1,000) - [(\$49 \times 1,000) + \$3.50 \times 2,000]\} \times \$54,000$  and US \$6,750  $\{ \$54,000 - \$47,250 \}$ , respectively. The realized gain is therefore US \$625  $\{ \$4,000 - \$6,750 \times 50\% \}$ . An entity has issued 1,000 ordinary shares with a par value of US \$10. and its credit balance in retained earnings is US \$5,000. Two proposals are under consideration. The first is a share split giving each shareholder more new shares for each share formerly held. The second is to declare and distribute a 10% share dividend.

**QUESTION: 251**

The share split proposal will <List A> earnings per share by <List B> than will the share

	List A	List B
A.	Increase	More
B.	Increase	Less
C.	Decrease	More
D.	Decrease	Less

**Answer: C**

The share split will double the number of shares outstanding to 2,000. The 10% share dividend will increase the number of outstanding shares to 1,111 ) The higher number of shares in the split will result in a lower earnings per share than will result from the share dividend. An entity has issued 1,000 ordinary shares with a par value of US \$10. and its credit balance in retained earnings is US \$5,000. Two proposals are under consideration. The first is a share split giving each shareholder two new shares for each share formerly held. The second is to declare and distribute a 10% share dividend.

**QUESTION: 252**

Under the share <List A>, the par value per outstanding share will <List B>. List A List B

	List A	List B
A.	Dividend	Increase
B.	Split	Increase
C.	Dividend	Decrease
D.	Split	Decrease

**Answer: D**

A share split results in a lower par value per share because the total number of shares increases but the total par value of outstanding share does not change.

**QUESTION: 253**

An entity had the following account balances at December 31 of Year 1

Ordinary shares, US \$10 par, 100,000 shares authorized, 80,000 shares issued and outstanding	US \$800,000
Share premium	US \$400,000
Retained earnings	US \$500,000

All shares outstanding were issued in a prior period for US \$15 per share. On January 5 of Year 2, 1,000 shares were purchased for the treasury for US \$17 per share. These treasury shares were sold on February 6 of Year 2, for US \$18 per share. The effect of the purchase and sale of the 1,000 treasury shares was to

- A. Increase equity by US \$1,000.
- B. Increase equity by US \$2,000.
- C. Increase equity by US \$3,000.
- D. Not change equity.

**Answer: A**

Using the cost method, the journal entry to record the purchase of the treasury shares is

Treasury shares	US \$17,000	
Cash		US \$17,000

The journal entry to record the sale is

Cash	US \$18,000	
Treasury shares		US \$17,000
Share premium from treasury shares		1,000

Consequently, the net effect is to increase equity by US \$1,000.

**QUESTION: 254**

On March 26, Company Z contracted with a consultant for services to be performed during the period from March 26 through April 30 in exchange for 10,000 treasury shares. The exchange took place on April 30. The treasury shares were acquired in January and were recorded at cost when the market price was US \$25 per share. The market price on March 26 was US \$21.50 per share. It was US \$23 per share on April 30. What should the per share amount recorded for the services have been?

- A. US \$21.50
- B. US \$22.25
- C. US \$23.00
- D. US \$25.00

**Answer: A**

A transaction is typically measured at the fair value of the consideration given up unless the fair value of the consideration received is more clearly evident. No information is given about the value of the services, so the market price of the treasury shares must be used. This price was US \$21.50 on March 26, the date of the agreement to trade the shares for services. Thus, the services to be received should have been measured on that date based on the price of the shares, or US \$21.50 per share. Because no gain or loss is recognized on transactions in treasury shares, the entry is to debit services for US \$21,500 ( $21.50 \times 10,000$ ), debit retained earnings or share premium from treasury share transactions for US \$3,500 [ $(\$25 - \$21.50) \times 10,000$ ], and credit treasury shares for US \$25,000 ( $25 \times 10,000$ ).

**QUESTION: 255**

Company M sold 1,000 treasury shares at US \$33 per share. The shares had originally been issued at US \$12 per share and had been repurchased at US \$27 per share. The par value is US \$5 per share. In the entry to record the reissuance using the cost method, what account should be credited?

- A. Retained earnings of US \$6,000
- B. Treasury shares of US \$28,000

- C. Paid-in capital in excess of par of US \$28,000.
- D. Share premium of US \$6,000.

**Answer: D**

Under the cost method, treasury shares are carried at cost. In this case, cost is US \$27,000 (1,000 shares x \$27). The journal entry to record a sale at US \$33 per share is

Cash	US \$33,000	
Treasury shares		US \$27,000
Share premium		6,000

**QUESTION: 256**

Which of the following brings in additional capital to the entity?

- A. Two-for-one share split.
- B Conversion of convertible bonds to ordinary shares
- C Exercise of warrants.
- D. Exercise of options purchased through an option exchange

**Answer: C**

Warrants are options that permit the holder to buy shares for a stated price. Their exercise results in inflows and the issuance of shares.

**QUESTION: 257**

A sound justification for an entity's repurchase of its own shares (e.g., treasury shares) is to

- A. Lower the debt to equity ratio of the entity.
- B. Increase the entity's total assets.
- C. Reduce the idle cash and increase marketable securities.
- D. Meet the share availability needs of a potential merger.

**Answer: D**

An entity has many reasons to repurchase its own shares. These include meeting the needs created by potential mergers or pension and profit-sharing plans. Also, management may want to buy out a dissident shareholder. Sometimes, an entity has excess cash and can find no better investment than its own shares. Moreover, management may believe the shares are selling for a low price for no apparent reason. Thus, a purchase may not only be a good investment but may also support the market price of the shares.

**QUESTION: 258**

Changes in accounting estimates are viewed as

- A. Extraordinary items.
- B. Errors in reported amounts in prior periods.
- C. Catch-up adjustments related to amounts reported in prior periods.
- D. Reassessments of current status and future benefits and obligations.

**Answer: D**

A change in accounting estimate adjusts the carrying amount of an asset or liability or the consumption of an asset. It results from reassessing the status and expected benefits and obligations related to assets and liabilities. It is based on new information and is not an error correction.

**QUESTION: 259**

On January 1, Year 1, an entity purchased a machine for US \$10,000. The estimated useful life was 10 years, with no residual value. The entity depreciates its property, plant, and equipment using the straight-line method. On January 1, Year 5, it was estimated that the machine had a remaining useful life of 3 years. Compute the entity's Year 5 depreciation expense for the machine.

- A. US \$1,000
- B. US \$2,000
- C. US \$3,000
- D. US \$6,000

**Answer: B**

The machine's net carrying amount at January 1, Year 5, is US \$6,000 (\$10,000 cost – \$4,000 accumulated depreciation for 4 years). A change in accounting estimate is applied prospectively. Thus, depreciation expense is US \$2,000 per year for the next 3 years.

**QUESTION: 260**

The following financial statement notes are extracts from the audited financial statements of public entities. Which note describes a change in accounting estimate?

- A. The entity changed its amortization of capital assets based on a reassessment of the useful lives of the assets. Accordingly, the entity changed its rate of amortization from 5% and 6% to 8% and 10% for machinery and equipment.

- B. Prior to Year 5, plant and equipment other than customer service replacement parts) were depreciated using the diminishing-balance method. Plant and equipment are now depreciated on a straight-line basis.
- C. During the year, the entity changed a method of accounting pursuant to a change in an International Financial Reporting Standard.
- D. Effective January 1, Year 5, the entity changed to the LIFO method of inventory valuation. Prior to Year 5, the FIFO method was used.

**Answer: A**

Accounting estimates, e.g., service lives, residual values, warranty costs, uncollectible accounts, and inventory obsolescence are a necessary part of preparing financial statements. However, they inevitably change as no casts occur and as additional experience and information are obtained. When altered conditions require a change in estimate, it is accounted for prospectively. Thus, a change in the estimate of the service lives of depreciable assets is a change in accounting estimate.

**QUESTION: 261**

When financial statements are being prepared, which of the following items requires that accountants estimate the effects of future conditions and events?

- A. The purchase price for an acquired building.
- B. The price of a marketable security.
- C. The amount of recoverable mineral reserves.
- D. The physical quantity of inventory.

**Answer: C**

Changes in estimates used in accounting are necessary consequences of periodic presentations of financial statements. Preparing financial statements requires estimating the effects of future events. Examples of items for which estimates are necessary are uncollectible receivables, inventory obsolescence, service lives and residual values of depreciable assets, warranty costs, periods benefited by a deferred cost, and recoverable mineral reserves.

**QUESTION: 262**

In the prior accounting period, an entity incorrectly expensed a newly purchased piece of equipment rather than establishing an asset balance and beginning to depreciate it over the estimated useful life of the item. To correct this material error in the single-period financial statements of the current period, the entity records which entry?

- A. Debit equipment  
Credit retained earnings  
Credit accumulated depreciation – equipment
- B. Debit retained earnings  
Debit accumulated depreciation – equipment  
Credit equipment
- C. Debit equipment  
Debit retained earnings  
Credit accumulated depreciation – equipment
- D. Debit equipment  
Debit accumulated depreciation – equipment  
Credit equipment

**Answer:** A

To correct the prior-period material error, the entity must, in the single-period statements issued for the current period, adjust the affected opening balances. Hence, the entity must debit equipment for its cost and credit accumulated depreciation for the depreciation expense appropriate for the first year of the estimated useful life. Retained earnings must be credited because the error understated profit or overstated loss in the prior period.

**QUESTION: 263**

A retrospective voluntary change in an accounting policy in the current period should be accounted for in comparative reports by

- A. An adjustment directly to equity balances for the first period presented and restatement of other comparative amounts.
- B. A line item on the current income statement for the cumulative effect of the change.
- C. Presentation of pro forma comparative information.
- D. Note disclosure only in the current period.

**Answer:** A

A voluntary change in accounting policy is applied retrospectively unless it is impracticable to determine period-specific effects or the cumulative effect. Retrospective application means adjusting the opening balances of equity for the first period presented and restating other comparative amounts.

**QUESTION: 264**

An accounting change requiring retrospective treatment is a change in

- A. The residual value of equipment.
- B. Depreciation methods from straight-line to diminishing-balance.

- C. An accounting policy inseparable from a change in an accounting estimate.
- D. A provision for warranty costs.

**Answer: B**

A change in depreciation methods is reported as a change in accounting policy. A voluntary change in accounting policy is applied retrospectively unless it is impracticable. Retrospective application means adjusting the opening balances of equity for the first period presented and restating other comparative amounts.

**QUESTION: 265**

An entity changes its method of accounting for depreciation during the current year because it believes that the result will be reliable and more relevant information. In its financial statements for the year, how should the entity report the adjustment resulting from the change in accounting policy if the practicability criterion is met?

- A. Not disclosed in the financial statements.
- B. Reported as an adjustment to beginning retained earnings of the earliest period presented.
- C. Disclosed as a separate type of depreciation expense, directly following depreciation expense for the current year.
- D. Included in the determination of profit or loss for the current period as a cumulative effect adjustment.

**Answer: B**

Under IAS 8, Accounting Policies, Changes in Estimates and Accounting Errors, a voluntary change in accounting policy should be applied retrospectively unless any resulting adjustment that relates to prior periods is not reasonably determinable. Thus, if it is not impracticable to apply the new policy retroactively, the policy should be applied to comparative information as far back as practicable. The entity should determine the cumulative effect on the opening and closing balance sheets for the earliest period for which it is practicable to do so.

**QUESTION: 266**

If ending inventory is underestimated due to an error in the physical count of items on hand, the cost of goods sold for the period will be =List A> and net earnings will be =List B>.



	List A	List B
A.	Underestimated	Underestimated
B.	Underestimated	Overestimated
C.	Overestimated	Underestimated
D.	Overestimated	Overestimated

**Answer: C**

Cost of goods sold equals beginning inventory, plus purchases, minus ending inventory. If ending inventory is underestimated, cost of goods sold will be overestimated for the period. If cost of goods sold is overestimated, profit for the period will be underestimated.

**QUESTION: 267**

The failure to record an accrued expense at year-end will result in which of the following overstatement errors in the financial statements prepared at that date?

	Profit	Working Capital	Cash
A.	No	No	Yes
B.	No	Yes	No
C.	Yes	No	No
D.	Yes	Yes	No

**Answer: D**

An accrued expense is an expense that has been incurred but not paid. The appropriate adjusting entry to record an accrued expense will increase an expense account and increase a liability account. The failure to record an accrued expense will result in an understatement of expenses leading to an overstatement of profit. The failure to record the increase in a liability account will result in an understatement of current liabilities leading to an overstatement of working capital. There will be no effect on cash.

**QUESTION: 268**

Which of the following errors is not self-correcting over two accounting periods?

- A. Failure to record accrued wages.
- B. Failure to record depreciation.
- C. Overstatement of inventory.
- B. Failure to record prepaid expenses.

**Answer: B**

A failure to record depreciation must be corrected because the effects of the error do not

automatically reverse in future periods. Expenses are understated in the year of the error, but no corresponding overstatement of expenses occurs in later years. An audit of an entity has revealed the following four errors that have occurred but have not been corrected:

1. Inventory at December 31. Year 3: US \$40,000. understated
2. Inventory at December 31. Year 4: US \$15,000, overstated
3. Depreciation for Year 3: US \$7,000, understated
4. Accrued expenses at December 31. Year 4: US \$10,000, understated

**QUESTION: 269**

The errors cause the reported profit for the year ending December 31. Year 4, to be

- A Overstated by US \$72,000.
- B Overstated by US \$65,000.
- C Understated by US \$28,000.
- D Understated by US \$45,000.

**Answer: B**

The effect of the understatement of the Year 3 year-end inventory (beginning inventory for Year 4) was to overstate Year 4 profit by US \$40,000. The reason is that beginning inventory is a component of cost of sales. The overstatement of the December 31. Year 4. inventory overstated Year 4 net income by US \$15,000 because the amounts in ending inventory are excluded from cost of sales. The understatement of Year 3 depreciation expense (a nominal account) has no effect on Year 4 net income. Finally, the failure to accrue US \$10,000 of expenses for Year 4 overstated Year 4 net income. The net effect of these Errors was a US \$65,000 (\$40,000 + \$15,000 + \$0 + \$10,000) overstatement. An audit of an entity has revealed the following four errors that have occurred but have not been corrected:

1. Inventory at December 31, Year 3: US \$40,000, understated
2. Inventory at December 31. Year 4: US \$15,000. overstated
3. Depreciation for Year 3: US \$7,000. understated
4. Accrued expenses at December 31, Year 4: US \$10,000, understated

**QUESTION: 270**

The errors cause the reported retained earnings at December 31. Year 4, to be

- A Overstated by US \$65,000.
- B Overstated by US \$32,000.
- C Overstated by US \$25,000.
- D Understated by US \$18,000.

**Answer: B**

The Year 3 inventory error reversed in Year 4 (excluding tax considerations) and therefore had no effect on reported retained earnings at December 31, Year 4. The US \$15,000 inventory error at year-end Year 4 and the failure to accrue US \$10,000 of expenses for Year 4 both overstated retained earnings as well as 4 year profit. The omission of US \$7,000 of depreciation overstated Year 3 net income and Year 3 and Year 4 retained earnings. Hence, the net effect of the errors on December 31, Year 4, retained earnings was a US \$32,000  $(\$0 + \$15,000 + \$7,000 + \$10,000)$  overstatement.

**QUESTION: 271**

For the past three years, an entity has failed to accrue unpaid wages earned by workers during the last week of the year. The amounts omitted which are considered material, were as follows.

December 31 Year 1 US \$56,000

December 31 Year 2 US \$51,000

December 31 Year 3 US \$64,000

What is included in the entry on December 31, Year 3, to correct for these omissions?

- A. Credit to wage expense for US \$64,000.
- B. Credit to wage expense for US \$51,000.
- C. Credit to wage expense for US \$13,000.
- D. Credit to retained earnings for US \$64,000.

**Answer: C**

Failing to record accrued wages is a self-correcting error. Expenses are understated in one year and overstated in the next, resulting in the correction of the error over the 2-year period. The Year 1 error overstated Year 1 earnings and understated Year 2 earnings by US \$56,000. Consequently, no correction is necessary for the Year 1 error. The Year 2 error overstated Year 2 profit before taxes and understated Year 3 profit before taxes by US \$51,000. The Year 3 error overstated Year 3 profit before taxes by US \$64,000. Thus, the net effect in Year 3 of the Year 2 and Year 3 errors is a US \$13,000  $(\$64,000 - \$51,000)$  overstatement. The correcting entry is to debit expense for US \$13,000, debit retained earnings for US \$51,000, and credit wages payable for US \$64,000.

**QUESTION: 272**

How are material prior-period errors in financial statements accounted for when comparative statements are issued?

- A. They are included in the determination of profit or loss for the current period.

- B. Prior-period financial statements are adjusted and reissued.
- C. They are corrected by restating comparative amounts for years when errors occurred.
- D. They are charged or credited directly to the closing balance of current-year retained earnings.

**Answer: C**

All material prior-period errors must be corrected retrospectively in the first set of financial statements issued after their discovery. This may be done by restating the comparative amounts for the prior periods when the error occurred. If the error occurred prior to the first period presented, the opening balances for the first period presented are restated. A material error is one that could, individually or collectively, affect the decisions of users of the financial statements. However, comparative information should be restated only if practicable.

**QUESTION: 273**

A change in an accounting estimate is shown on the income statement

- A. Only in the relevant account
- B. In a separate section entitled extraordinary items.
- C. In a separate section after continuing operations but before extraordinary items.
- D. As a cumulative-effect adjustment.

**Answer: A**

A change in an accounting estimate is accounted for prospectively and is shown on the income statement only in the relevant account. The effect of the change is included in the same income statement classification as the previous estimate. However, prior-period statements and opening balances are not adjusted.

**QUESTION: 274**

If certain goods owned by an entity were not recorded as a purchase and were not counted in ending inventory, in error, then

- A. Cost of goods sold for the period will be understated.
- B. Cost of goods sold for the period will be overstated.
- C. Profit for the period will be understated.
- D. There will be no effect on cost of goods sold or profit for the period.

**Answer: D**

The effects of the errors on cost of goods sold are offsetting. Purchases, which increase cost of goods sold, and ending inventory, which decreases cost of goods sold,

are understated by the same amount. Neither cost of goods sold nor profit is affected.

**QUESTION: 275**

Because changes in accounting estimates relate to changes in circumstances in the [List A] period, they should be reported [List B]\_ List A List B

	List A	List B
A.	Current	Not at all
B.	Current	Prospectively
C.	Prior	Retroactively
D.	Prior	Not at all

**Answer: B**

Changes in accounting estimates arise as new events occur, as more experience is obtained, or as additional evidence is acquired. A change should be reported in the period in which it occurs, as well as prospectively if future periods are effected. Retroactive reporting is impracticable because of it would result in continual adjustments of prior years' financial statements.

**QUESTION: 276**

An audit of an entity records for its first year of operations determined that the following errors v. re made at the balance sheet date: Failed to accrue US \$50,000 interest expense. Failed to record depreciation expense on office equipment of US \$80,000. Failed to amortize prepaid rent expense of US \$100,000 Failed to defer recognition of prepaid advertising expense of US \$60,000. The net effect of these errors was to overstate profit by

- A.. US\$130,000
- B. US\$170,000
- C. US\$230,000
- D. US\$290,000

**Answer: B**

The computation is as follows:

Error	Effect on Expense		Effect on Profit	
Failure to accrue interest expense	Understate	US \$ 50,000	Overstate	US \$ 50,000
Failure to record depreciation	Understate	80,000	Overstate	80,000
Failure to amortize prepaid rent expense	Understate	100,000	Overstate	100,000
Failure to defer recognition of prepaid advertising	Overstate	60,000	Understate	60,000
Totals	Understate	US \$170,000	Overstate	US \$170,000

**QUESTION: 277**

An enterprise changes its method of accounting for depreciation during the current year because it believes that the result will be a more appropriate presentation in the financial statements. In its income statement for the year, how should the enterprise report the adjustment resulting from the change in accounting policy if all relevant amounts are practicably determinable?

- A. Not disclosed in the financial statements.
- B. Included in the determination of profit or loss for the current period\_
- C. Disclosed as a separate type of depreciation expense, directly following depreciation expense for the current year
- D. Reported as an adjustment to beginning retained earnings for the first period presented.

**Answer: D**

A change in accounting policy should be applied retrospectively unless it is impracticable to determine period-specific effects or the cumulative effect\_ Retrospective application means adjusting the opening balances of equity(e.g. retained earnings) for the first period presented and restating other comparative amounts.

**QUESTION: 278**

On September 22, Year 1, a corporation purchased merchandise from an unaffiliated foreign entity for 10,000 units of the foreign entity's local currency. On that date, the spot rate was US \$.55. The corporation paid the bill in full on March 20, Year 2, when the spot rate was US \$.65. The closing rate was US \$.70 on December 31, Year 1. What amount should the corporation report as a foreign currency transaction loss in its income statement for the year ended December 31, Year 1?

- A. US \$0
- B. US \$500
- C. US \$1,000

D. US \$1.500

**Answer: D**

A receivable or payable fixed in a foreign currency is adjusted to its current exchange rate at each balance sheet date. The resulting gain or loss should ordinarily be included in determining profit or loss. It is the difference between the spot rate on the date the transaction originates or the rate applied in the prior year) and the closing rate. Thus, the Year 1 transaction loss for Yumi Corp. is US \$1,500 [10.000 units\$0.55 - \$0.70)].

**QUESTION: 279**

A reporting entity consolidates a foreign operation. This operation maintains its booksits functional currency, which not that of a hyperinflationary economy. How should the amounts in the foreign operation's financial statements be translated into the presentation currency?

- A. Assets are translated at the exchange rates effect at the translation dates.
- B. All amounts are translated at the closing rate for the most recent balance sheet date.
- C. Exchange differences are recognized equity.
- D. Expenses are translated at the closing rate.

**Answer: C**

An exchange difference arises when a given amount of one currency is translated into another currency at different rates. Exchange differences are recognized in a separate component of equity when they arise from translation of functional currency amounts into the presentation amounts. Such exchange difference are not recognized in profit or loss because they have little, if any, direct effect on operational case flows.

**QUESTION: 280**

On June 1 of the current year, XYZ Company purchased British pounds for 10,000 euros. It also acquired land for 25,000 euros. At the end year or XYZ Company's fiscal year on December 31, the spot rate for the pound was 1.20 euros. The land had a value of 27,500 euros. XYZ Company records its nonmonetary items at historical cost. Which of the following is the correct presentation of this transaction on XYZ Company's balance sheet?

Pounds Land

- A. €10,000 €25,000
- B. €10,000 €27,500
- C. €12,000 €25,000
- D. €12,000 €27,500

**Answer: C**

At the balance sheet date, monetary items are reported at the closing rate, which is often the spot rate on the balance sheet date. Nonmonetary items measured at historical cost reported at the rate on the transaction date. Thus, the pounds are reported at €12.0001.20 (£ x €10,000), and the land is reported at €25,000.

**QUESTION: 281**

A U.S. company and a European company purchased the same stock on a European stock exchange and held the stock for one year. If the value of the euro weakened against the U.S. dollar during the period, in comparison with the European company's return, the U.S. company's return will be

- A. Lower.
- B. Higher.
- C. The same.
- D. Indeterminate from the information provided.

**Answer: A**

Because the return to the U.S. company is adversely affected and the return to the European company is unaffected, the return to the U.S. company will definitely be lower than the return to the European company.

**QUESTION: 282**

For the past several years, Company S has invested in the ordinary stock of Company A. Company S currently owns approximately 13% of the total of Company A's outstanding voting ordinary stock. Recently, management of the two companies have discussed a possible combination of the two entities. If they do decide to combine, how should the resulting combination be accounted for?

- A. Uniting of interests
- B. Acquisition.
- C. Part purchase, part uniting of interests.
- D. Joint venture

**Answer: B**

IFRS 3, Business Combinations, requires that all business combinations within its scope be accounted for using the acquisition method.



**QUESTION:283**

To effect a business combination initiated on July 1, Year 1, Company P acquired all the outstanding ordinary shares of Company S for cash equal to the carrying amount of Company S's net assets. The carrying amounts of Company S's assets and liabilities approximated their fair values, except that the carrying amount of its building was more than fair value. In preparing Company P's December 31, Year 1, consolidated income statement, what is the effect of recording the assets acquired and liabilities assumed at fair value and should goodwill amortization be recognized?

	<u>Depreciation Expense</u>	<u>Goodwill Amortization</u>
A.	Lower	Yes
B.	Higher	Yes
C.	Lower	No
D.	Higher	No

**Answer: C**

A business combination is accounted for as an acquisition regardless of the form of consideration given. Thus, assets acquired and liabilities assumed should be recorded at their fair values. The differences between fair values and carrying amounts will affect profit or loss when related expenses are incurred. The effect of recording the building at fair value in the consolidated balance sheet instead of its higher carrying amount on Company S's books will be to decrease future depreciation. If the building is to be used, fair value is its current replacement cost for similar capacity unless expected use indicates a lower value to the acquirer. If the building is to be sold, it should be reported at fair value minus cost to sell. The excess of the sum of the consideration transferred, any noncontrolling interest, and any previously held equity interest over the acquisition-date fair value of the net assets acquired will be recognized as goodwill. This amount will be tested for impairment but not amortized.

**QUESTION: 284**

Company P paid US \$600,000 for all of the outstanding ordinary stock of Company S in a business combination initiated and completed in the current year. At that time, Company S had the following condensed balance sheet.

	<u>Carrying Amounts</u>
Current assets	US \$ 80,000
Plant and equipment, net	760,000
Liabilities	400,000
Equity	440,000

The fair value of the plant and equipment was US \$120,000 more than its carrying amount. The fair values and carrying amounts were equal for all other assets and liabilities. What amount of goodwill, related to Company S's acquisition, should Company P report in its consolidated balance sheet?

A. US \$40,000

- B. US \$80,000
- C. US \$120,000
- D. US \$160,000

**Answer: A**

Under the acquisition methods, assets acquired and liabilities assumed should be recorded at their acquisition-date fair values\_ Any excess of the sum of the considerations transferred, any noncontrolling interest, and any previously held equity interest over the fair value of the net assets acquired is recorded as goodwill. After adjusting the net plant and equipment, and given that other items are stated at fair value. the fair value of the net assets acquired is US \$560,000 [\$80,000 current assets +\$760,000 + \$120,000) plant and equipment- \$400,000 liabilities]. Hence, goodwill is US \$40,000\$600,000 consideration - \$560,000).

**QUESTION: 285**

In a business combination. the sum of the amounts assigned by the acquiring entity to assets acquired and liabilities incurred and assumed exceeds the consideration paid for the acquired entity. The excess should be reported as a

- A. Deferred credit
- B. Reduction of the amounts assigned to current assets and a deferred credit for any unallocated portion.
- C. Gain immediately in profit or loss.
- D. Pro rata reduction of the amounts assigned to all acquired assets and a gain for any unallocated portion.

**Answer: C**

In a business combination. any excess of the fair value of the net assets acquired over the sum of the considerations transferred, any noncontrolling interests, and any previously held equity interest must be recognized immediately in profit or loss as a gain. Before concluding that the identification and measurement of the acquiree's assets, liabilities, etc., must be reassessed.

**QUESTION: 286**

Business combinations are accomplished either through a direct acquisition of assets and liabilities by a surviving corporation or by stock investments in one or more companies. A parent-subsidiary relationship always arises from a

- A. Tax-free reorganization.
- B. Vertical combination.

- C. Horizontal combination.  
 D. Greater than 50% stock investment in another entity.

**Answer: D**

A parent-subsidary relationship arises from an effective investment in the stock of another enterprise in the stock of 50%. The financial statements for the two companies ordinarily should be presented on a consolidated basis. To the extent the corporation is not wholly-owned, a noncontrolling interest is presented.

**QUESTION: 287**

Entity A acquires entity B for US \$1,000,000. At the time of the acquisition, the net fair value of the identifiable assets, liabilities, and contingent liabilities recognized had a carrying amount of US \$900,000 and a fair value of US \$800,000. The amount of goodwill entity A will record on the acquisition date is

- A. US \$0  
 B. US \$100,000  
 C. US \$200,000  
 D. US \$300,000

**Answer: C**

Goodwill equals the excess of the acquisition cost over the acquirer's interest in the net fair value of the identifiable assets, liabilities and contingent liabilities recognized. Consequently goodwill is US \$200,000 (\$1,000,000 – \$800,000).

**QUESTION: 288**

A conglomerate entity acquired 100% of the net assets of a target entity for US \$900 cash. The target entity's balance sheet just prior to the acquisition is presented below.

Target Entity (as of acquisition date)		
	Carrying Amount	Fair Value
Cash	US \$ 100	US \$100
Receivables	200	200
Inventory	150	200
Property, plant, and equipment (net)	600	400
Total assets	<u>US \$1,050</u>	<u>US \$900</u>
Current liabilities	US \$ 200	US \$200
Share capital	200	
Retained earnings	650	
Total liabilities and equity	<u>US \$1,050</u>	

The amount of goodwill to be recorded by the conglomerate entity related to its purchase of the target entity is

- A. US \$(200)
- B. US \$50
- C. US \$200
- D. None of the answers are correct

**Answer: C**

Goodwill is the excess of the cost over the net fair value of the acquired identifiable assets, liabilities, and contingent liabilities recognized. This net fair value equals the sum of cash, receivables, inventory, and PPE. minus liabilities. Hence, the net fair value acquired is US \$700. and goodwill is US \$200 (\$900 cost - \$700).

**QUESTION: 289**

When the equity method is used to account for the investment in an associate, the recording of the receipt of a cash distribution from the investee will result in

- A The recognition of investment income.
- B A reduction in the investment balance.
- C An increase in a liability account.
- D An increase in a special equity account.

**Answer: B**

When the equity method is used, the investment is initially recorded at cost on the entity's books. The carrying amount is subsequently adjusted to recognize the profits or losses of the associate after the date of acquisition. Dividends received from an associate reduce the carrying amount.

**QUESTION: 290**

A corporation acquires a 30% voting interest in another corporation. In this situation, the long-term investment is generally accounted for on the investor corporation's books using which of the following reporting methods?

- A. Lower-of-cost-or-market.
- B. Cost.
- C. Consolidated.
- D. Equity.

**Answer: D**

If an investor can exercise significant influence over an investee, the investment should be accounted for by the equity method. When a corporation owns 20% or more of the voting power of the investee, the ability to exercise significant influence is presumed.

**QUESTION: 291**

Entity X owns 90% of entity Y. Early in the year, X lent Y U.S. \$1,000,000. No payments have been made on the debt by year-end. Proper accounting at year-end in the consolidated financial statements would

- A. Eliminate 100% of the receivable, the payable, and the related interest.
- B. Eliminate 100% of the receivable and the payable but not any related interest.
- C. Eliminate 90% of the receivable, the payable, and the related interest.
- D. Eliminate 90% of the receivable and the payable but not any related interest.

**Answer: A**

In a consolidated balance sheet, reciprocal balances, such as receivables and payables, between a parent and a consolidated subsidiary should be eliminated in their entirety regardless of the portion of the subsidiary's shares held by the parent. Thus, all effects of the US \$1,000,000 loan should be eliminated in the preparation of the year-end consolidated balance sheet.

**QUESTION: 292**

Consolidated financial statements are typically prepared when one entity has a majority voting interest in another unless

- A. The subsidiary is a financial institution.
- B. The fiscal year-ends of the two entities are more than 3 months apart.
- C. Control does not rest with the majority owners.
- D. The two entities are in unrelated industries, such as manufacturing and real estate.

**Answer: C**

Consolidation normally is required when one entity owns, directly or indirectly, more than 50% of the outstanding voting interests of another entity. However, a majority-owned subsidiary is not consolidated if control does not rest with the majority owners.

**QUESTION: 293**

A 70%-owned subsidiary declares and pays a cash dividend. What effect does the dividend have on the retained earnings and noncontrolling interest balances in the parent's consolidated balance sheet?

- A No effect on either retained earnings or noncontrolling interest.
- B. No effect on retained earnings and a decrease in noncontrolling interest.
- C. Decreases in both retained earnings and noncontrolling interest.
- D A decrease in retained earnings and no effect on noncontrolling interest.

**Answer: B**

The parent's investment in subsidiary account and its proportionate share of the subsidiary's equity accounts, which include retained earnings, are eliminated in a consolidation. The remainder of the subsidiary's equity is reported separately as the noncontrolling interest. Thus, consolidated retained earnings is essentially the parent's retained earnings at year-end. The subsidiary's cash dividend reduces its retained earnings balance and therefore the noncontrolling interest but not the parent's retained earnings.

**QUESTION: 294**

P Co. purchased term bonds at a premium on the open market. These bonds represented 20% of the outstanding class of bonds issued at a discount by S Co., P's wholly owned subsidiary. P intends to hold the bonds until maturity. In a consolidated balance sheet, the difference between the bond carrying amounts of the two companies is

- A. Included as a decrease in retained earnings.
- B. Included as an increase in retained earnings.
- C. Reported as a deferred debit to be amortized over the remaining life of the bonds.
- D Reported as a deferred credit to be amortized over the remaining life of the bonds.

**Answer: A**

Because a consolidated financial statement should include both P and S as a single consolidated reporting entity, the purchase of the outstanding bonds of S by P at a premium was in substance a retirement of debt for more than the debt's carrying amount. This transaction should be reflected in the consolidated income statement for the year of the purchase as a constructive loss from the retirement of debt. Hence, the effect on the balance sheet is to decrease retained earnings by an amount equal to the premium plus the unamortized discount before the tax effect.

**QUESTION: 295**

What is the method of presenting a noncontrolling interest in a consolidated balance sheet?

- A. As a separate item within the deferred credits section\_
- B. As a deduction from contra to) goodwill from consolidation. if any.
- C. By means of notes to the balance sheet.
- D. As a separate item within the equity section.

**Answer: D**

A noncontrolling is classified as an equity account and separated from the equity of majority shareholders within that section.

**Section 3: Sec Three (296 to 299)**

**Details:** Financial accounting I

**QUESTION: 296**

Ordinary shareholders with preemptive rights are entitled to

- A. Vote first at annual meetings.
- B. Purchase any additional bonds sold by the entity.
- C. Purchase any additional shares sold by the entity.
- D. Gain control of the entity in a proxy fight.

**Answer: C**

Preemptive rights protect ordinary shareholders, proportional ownership interests from dilution in value. A secondary purpose is to maintain the shareholders' control of the entity. Accordingly, the preemptive right, whether granted by statute or by the corporate charter, grants ordinary shareholders the power to acquire on a pro rata basis any additional ordinary shares sold by the entity. Preemptive rights also apply to debt convertible into ordinary shares.

**QUESTION: 297**

Participating preference shareholders are entitled to

- A. Monitor any sinking funds for the purchase and retirement of debt.
- B. Vote at all annual meetings.
- C. Convert their shares into ordinary shares.
- D. Share in the entity's earnings beyond the stated dividend level.

**Answer: D**

Participating preference shareholders are entitled to share in the earnings of the entity. They participate in earnings distributions under set terms and conditions. Hence, after the

stated preference dividend is paid, and ordinary shareholders receive an equal dividend, any remaining dividends are allocated to all shareholders in proportion to the par values of their shares.

**QUESTION: 298**

Preference shares are securities with characteristics of both ordinary shares and bonds. Preference shares have <List A> like ordinary shares and <List B> like bonds.

	List A	List B
A.	A maturity date	A fixed periodic payment
B.	No maturity date	No fixed periodic payment
C.	A maturity date	No fixed periodic payment
D.	No maturity date	A fixed periodic payment

**Answer: D**

Like ordinary shares but unlike bonds), preference shares have no maturity date, although certain preference shares (transient preference shares) must be redeemed within a short time e.g., 5 to 10 years). Like bonds but unlike ordinary shares), preference shares have a fixed periodic payment. The fixed payment is in the form of a stated dividend in the case of the preference shares and interest payments in the case of bonds. However, preference dividends, unlike interest, do not become an obligation unless declared.

**QUESTION: 299**

Which of the following is usually not a feature of cumulative preference shares?

- A. Has priority over ordinary shares with regard to earnings.
- B. Has priority over ordinary shares with regard to assets.
- C. Has voting rights.
- D. Has the right to receive dividends in arrears before ordinary share dividends can be paid.

**Answer: C**

Preference shares do not usually have voting rights. Preference shareholders are usually given the right to vote for directors only if the entity has not paid the preference dividend for a specified period of time, such as 10 quarters. Such a provision is an incentive for management to pay preference dividends.



**QUESTION: 1**

If an entity has outstanding bonds with a sinking fund provision and if interest rates have <List A> since the bonds were issued, the entity would realize a savings in meeting its sinking fund obligations by <List B>.

	List A	List B
A.	Increased	Buying back bonds in the open market
B.	Remained constant	Calling in a portion of the bonds at face value
C.	Increased	Calling in a portion of the bonds at face value
D.	Decreased	Buying back bonds in the open market

**Answer: A**

If interest rates have increased, the prices of outstanding bonds must decrease so that their yields will reach the market rate. Hence, the bonds will be selling at a discount (below face value) in the open market. Retiring a portion of the outstanding bonds by buying them in the open market at the discounted price will be cheaper than calling a portion of the bonds at face value.

**QUESTION: 2**

Convertible bonds and bonds issued with warrants differ in that

- A. Convertible bonds have lower coupon rates than straight bonds, while bonds issued with warrants have higher coupon rates than straight bonds.
- B. Convertible bonds have higher coupon rates than straight bonds, while bonds issued with warrants have lower coupon rates than straight bonds.
- C. Convertible bonds remain outstanding after the bondholder exercises the right to become an ordinary shareholder, while bonds that are issued with warrants do not.
- D. Bonds that are issued with warrants remain outstanding after the bondholder exercises the right to become an ordinary shareholder, while convertible bonds do not.

**Answer: D**

Warrants are usually detachable. They are options to purchase equity securities and should be separately accounted for. A capital gain results if the share price rises above the option price. The bonds remain outstanding if the warrants are exercised. Convertible bonds must be surrendered when the conversion privilege is exercised. Under IFRSs, the equity and debt features of convertible bonds are separately accounted for.

**QUESTION:3**

Zero-coupon bonds

- A. Sell for a small fraction of their face value because their yield is much lower than the market rate.
- B. Increase in value each year as they approach maturity, providing the owner with the total payoff at maturity.
- C. Are redeemable in measures of a commodity such as barrels of oil, tons of coal, or ounces of rare metal (e.g., silver).
- D. Are high-interest-rate, high-risk, unsecured bonds that have been used extensively to finance leveraged buyouts.

**Answer:** B.

Zero-coupon bonds sell at a deep discount and increase in value each year until maturity. These bonds do not pay interest.

**QUESTION:** 4

Bondholders are assured of protection against inflation if they hold

- A. Income bonds.
- B. Convertible bonds.
- C. Mortgage bonds.
- D. Indexed bonds.

**Answer:** D

The interest payments on indexed or purchasing power bonds are based on an inflation index, such as the consumer price index. Thus, interest paid to bondholders rises automatically when the inflation rate rises.

**QUESTION:** 5

From the viewpoint of the investor, which of the following securities provides the least risk?

- A. Mortgage bond.
- B. Subordinated debenture.
- C. Income bond.
- D. Debentures.

**Answer:** A

A mortgage bond is secured with specific fixed assets, usually real property. Thus, under

the rights enumerated in the bond indenture, creditors will be able to receive payments from liquidation of the property in case of default. In a bankruptcy proceeding, these amounts are paid before any transfers are made to other creditors, including those preferences. Hence, mortgage bonds are less risky than the others listed.

**QUESTION: 6**

Which of the following classes of securities are listed in order from lowest risk/opportunity for return to highest risk/opportunity for return?

- A. Corporate first mortgage bonds; corporate income bonds; preference shares.
- B. Corporate income bonds; corporate mortgage bonds; subordinated debentures.
- C. Ordinary shares; corporate first mortgage bonds, corporate second mortgage bonds. D Preference shares; ordinary shares; corporate debentures.

**Answer: A**

The general principle is that risk and return are directly correlated. Corporate first mortgage bonds are less risky than income bonds or shares because they are secured by specific property. In the event of default, the bondholders can have the property sold to satisfy their claims. Holders of first mortgages have rights paramount to those of any other parties, such as holders of second mortgages. Income bonds pay interest in the event the corporation earns income. Thus, holders of income bonds have less risk than shareholders because meeting the condition makes payment of interest mandatory. Preference shareholders receive dividends only if they are declared, and the directors usually have complete discretion in this matter. Also, shareholders have claims junior to those of debt holders if the entity is liquidated.

**QUESTION: 7**

An entity is arranging debt financing for the purchase of a new piece of equipment that has a 5-year expected useful life. Which of the following alternative financing arrangements has the lowest effective annual percentage rate if each has a quoted nominal rate of 9.5%?

- A. A 5-year term loan with interest compounded annually.
- B. A 10-year term loan with interest compounded semiannually.
- C. A 5-year term loan with interest compounded quarterly.
- D. A 10-year term loan with interest compounded monthly.

**Answer: A**

For any given quoted nominal rate, the least frequent compounding is associated with the lowest effective annual percentage cost. Annual compounding is less frequent than

semiannual, quarterly, or monthly. The term of the bond is not relevant to the calculation of the effective annual percentage cost of financing.

**QUESTION: 8**

How much must the stock be worth at expiration for a call holder to break even if the exercise price is US \$60 and the call premium was US \$3?

- A. US \$57.00
- B. US \$60.00
- C. US \$61.50
- D. US \$63.00

**Answer: D**

Because the call premium is US \$3, the stock price must be at least US \$63 (\$60 exercise price + \$3 call premium).

AA Company has purchased one share of QQ Company ordinary stock and one put option. It has also sold one call option. The options are written on one share of QQ Company ordinary stock and have the same maturity date and exercise price. The exercise price (US \$40) is the same as the share price. Moreover, the options are exercisable only at the expiration date.

**QUESTION: 9**

Assume that the value of a share of QQ Company ordinary stock at the expiration date is either US \$30 or US \$45. What is the difference in the net payoff on the portfolio because of a difference in the stock price at the maturity date?

- A. US \$10.00
- B. US \$7.50
- C. US \$5.00
- D. US \$0

**Answer: D**

If the stock price at the maturity date is US \$30, AA Company will have a share of stock worth US \$30 and a put option worth US \$10 (\$40 exercise price - \$30 stock price). The call option will be worthless. Hence, the net payoff is US \$40 (\$30 + \$10). If the stock price at the maturity date is US \$45, the share of stock will be worth US \$45, the put will be worthless, and the loss on the call will be US \$5 (\$45 - \$40). Thus, the net payoff will be US \$40 (\$45 - \$5). Consequently, the difference in the net payoff on the portfolio because of a difference in the stock price at the maturity date is US \$0 (\$40 - \$40).

**QUESTION: 10**

Which of the following securities is likely to o e the least risk?

- A. Income bonds
- B. Debentures
- C. Subordinated determined
- D. First mortgage bonds

**Answer: D**

First-mortgage bonds are backed by fixed assets.

**QUESTION: 11**

The correct equation for calculating the approximate percentage cost, on an annual basis, of not taking trade discounts is

- A. 
$$\frac{\text{Discount \%}}{100 - \text{Discount \%}} \times \frac{360}{[\text{Days credit is outstanding} - \text{Discount period}]}$$
- B. 
$$\frac{\text{Discount \%}}{100} \times \frac{360}{[\text{Days credit is outstanding} - \text{Discount period}]}$$
- C. 
$$\frac{100 - \text{Discount \%}}{\text{Discount \%}} \times \frac{360}{[\text{Days credit is outstanding} - \text{Discount period}]}$$
- D. 
$$\frac{\text{Discount \%}}{100 - \text{Discount \%}} \times \frac{[\text{Days credit is outstanding} - \text{Discount period}]}{360}$$

**Answer: A**

The first term of the formula represents the periodic cost of the trade discount, calculated as the cost per unit of trade credit discount %) divided by the funds made available by not taking the discount 100 - discount %). The second term represents the number of times per year this cost is incurred. The multiple of these terms is the approximate annual percentage cost of not taking the trade discount. A precise formula would incorporate the effects of compounding when calculating the annual cost.

**QUESTION: 12**

An entity obtaining short-term financing with trade credit will pay a higher percentage financing cost, everything else being equal, when the

- A. Discount percentage is lower.
- B. Items purchased have a higher price.
- C. Items purchased have a lower price.
- D Supplier offers a longer discount period.

**Answer: D**

If the discount period is longer, the days of extra credit obtained by forgoing the discount are fewer. Assuming other factors are constant, the result is that the cost of trade credit, that is, the cost of not taking the discount, is greater\_

**QUESTION: 13**

An entity has accounts payable of US \$5 million with terms of 2% discount within 15 days, net 30 days 2115 net 30 It can borrow funds from a bank at an annual rate of 12%, or it can wait until the 30th day when it will receive revenues to cover the payment If it borrows funds on the last day of the discount period in order to obtain the discount, its total cost will be

- A. US \$51,000 less.
- B. US \$75,500 less.
- C. US \$100,000 less.
- D. US \$24,500 more

**Answer: B.**

The interest cost of borrowing US \$4,900,000 (\$5,000,000 98%) to take advantage of the discount is US \$24,500 [ $\$4,900,000 \times 12\% \times \frac{15}{360}$ ], and the total cost will be US \$4,924,500. The total cost if the discount is not taken will be 5,000,000, a difference of US \$75,500.

**QUESTION: 14**

A short-term bank loan will have a higher effective financing cost if it has which combination of characteristics?

- A. A 10% compensating balance and regular interest.
- B. A 10% compensating balance and discount interest.
- C A 20% compensating balance and regular interest

D A 20% compensating balance and discount interest

**Answer: D**

The most costly combination of characteristics is a higher compensating balance and discount interest. The higher the compensating balance, the higher the portion of the loan funds that must be left on deposit with the lender. Hence, the interest paid is charged on a smaller amount of funds available to be used by the borrower, and the effective cost is higher. Also, discount interest is deducted from the loan funds in advance, resulting in a further increase in the effective financing cost.

**QUESTION: 15**

The credit instrument known as a banker's acceptance

- A. Calls for immediate payment upon delivery of the shipping documents to the bank's customer and acceptance of Hoods by the bank.
- B. Involves an invoice being signed by the banker upon receipt of goods, after which both the banker and the seller record the transaction on their respective books.
- C. Is a time draft payable on a specified date and guaranteed by the bank.
- D. Is a method of sales financing in which the bank retains title to the goods until the buyer has completed payment

**Answer: C**

A time draft trade acceptance) is a form of commercial draft because it is drawn by a seller on the buyer: that is, it calls for the buyer to pay a specified amount. The draft and the shipping documents related to the goods are then sent to the buyer's bank, which transmits the draft to the buyer. The buyer effects the draft by signing it. A time draft, however, is similar to a promissory note because it is payable at a specific time in the future rather than upon acceptance by the buyer, which is characteristic of a sight draft. If a seller is reluctant to ship goods because of concern about the buyer's ability to pay a time draft, the seller's bank may, for a fee, guarantee payment This banker's acceptance is an assumption of the obligation to pay at the due date.

**QUESTION: 16**

An example of secured short-term financing is

- A. Commercial paper.
- B. A warehouse receipt
- C. A revolving credit agreement.
- D. Trade credit

**Answer:** B.

A document of title is usually issued by a bailee covering goods in the bailee's possession or care UCC 1-201). It represents ownership of the goods and is ordinarily needed to obtain the goods from the bailee. The two major types of documents of title are bills of lading issued by carriers) and warehouse receipts\_ A warehouse receipt is issued by a person engaged in the business of storing goods for hire. Security for short-term inventory financing can be arranged if the debtor places its inventory under the control of the lender or its agent e.g., a public warehouse), and the lender holds the warehouse receipts.

**QUESTION:** 17

Factoring is the

- A. Selling of accounts receivable by one entity to another.
- B. Selling of inventory by one entity to another.
- C. Conversion of accounts receivable to bad debt on financial statements for accounts that are long overdue.
- D. Adjustment of inventories on financial statements for supplies that have become obsolete.

**Answer:** A

A factor purchases an entity's accounts receivable and assumes the risk of collection. The seller receives money immediately to reinvest in new inventories. The financing cost is usually high: about 2 points or more above prime, plus a fee for collection. Factoring has been traditional in the textile industry for years, and recently companies in many industries have found it an efficient means of operation. An entity that uses a factor can eliminate its credit department, accounts receivable staff, and bad debts. These reductions in costs can more than offset the fee charged by the factor, which can often operate more efficiently than its clients because of the specialized nature of its service.

**QUESTION:** 18

The following forms of short-term borrowing are available to an entity\_

Floating lien

Factoring

Revolving credit

Chattel mortgages Bankers' acceptances . Lines of credit

Commercial paper

The forms of short-term borrowing that are unsecured credit are



- A. Floating lien, revolving credit, chattel mortgage, and commercial paper
- B. Factoring, chattel mortgage, bankers' acceptances, and line of credit
- C. Floating lien, chattel mortgage, bankers' acceptances, and line of credit
- D. Revolving credit, bankers' acceptances, line of credit, and commercial paper

**Answer: D**

An unsecured loan is a loan made by a bank based on credit information about the borrower and the ability of the borrower to repay the obligation. The loan is not secured by collateral, but is made on the signature of the borrower. Unsecured credit is not backed by collateral. Revolving credit, bankers' acceptances, lines of credit, and commercial paper are all unsecured means of borrowing. A chattel mortgage is a loan secured by personal property movable property such as equipment or livestock). A floating lien is also secured by property, such as inventory, the composition of which may be constantly changing. Factoring is a form of financing in which receivables serve as security.

**QUESTION: 19**

Short-term, unsecured promissory notes issued by large entities are known as

- A. Agency securities.
- B. Bankers acceptances.
- C. Commercial paper.
- D. Repurchase agreements.

**Answer: C**

Commercial paper is the term for the short-term (typically less than 9 months), unsecured, large denomination (often over US \$100,000) promissory notes issued by large, creditworthy companies to other companies and institutional investors. In many instances, the maturity date is only a few days after issuance.

**QUESTION: 20**

An entity borrows funds from its bank for a one-year period. The bank charges interest at a nominal rate of 15% per annum, on a discount basis, and requires a 10% compensating balance. The effective annual interest rate on the loan is

- A. 16.67%
- B. 17.65%
- C. 20.00%
- D. 25.00%

**Answer: C**

Discount interest is subtracted before the loan proceeds are paid to the borrower. A compensating balance is an amount that the borrower must keep on deposit with the lender. The effective annual interest rate is increased by both the discount interest arrangement and by the compensating balance requirement. The effective rate equals the nominal rate divided by one minus the sum of the nominal rate and the compensating balance percentage, or 20%  $[\frac{.15}{1 - (.15 + .1)}]$ .

**QUESTION: 21**

An entity has made the decision to finance next year's capital projects through debt rather than additional equity. The benchmark cost of capital for these projects should be the

- A. Before-tax cost of new-debt financing.
- B. After-tax cost of new-debt financing.
- C. Cost of equity financing.
- D. Weighted-average cost of capital.

**Answer: D**

A weighted average of the costs of all financing sources should be used, with the weights determined by the usual financing proportions. The terms of any financing raised at the time of initiating a particular project do not represent the cost of capital for the entity. When an entity achieves its optimal capital structure, the weighted-average cost of capital is minimized. The cost of capital is a composite, or weighted average, of all financing sources in their usual proportions. The cost of capital should also be calculated on an after-tax basis.

**QUESTION: 22**

When an entity increases its degree of financial leverage (DFL), the

- A. Equity beta of the entity falls.
- B. Systematic risk of the entity falls.
- C. Systematic risk of the entity rises.
- D. Standard deviation of returns on the equity of the entity rises.

**Answer: D**

The DFL equals the percentage change in EPS (earnings available to ordinary shareholders) divided by the percentage change in net operating profit or loss. When the DFL rises, fixed interest charges and the riskiness of the entity rise. As a result, the

variability of returns will increase. In other words, the standard deviation of returns of the entity rises.

**QUESTION: 23**

In its first year of operations, an entity had US \$50,000 of fixed operating costs. It sold 10,000 units at a US \$10 unit price and incurred variable costs of US \$4 per unit. If all prices and costs will be the same in the second year and sales are projected to rise to 25,000 units, what will the degree of operating leverage (the extent to which fixed costs are used in the entity's operations) be in the second year?

- A. 1.25
- B. 1.50
- C. 2.0
- D. 6.0

**Answer: B.**

The DOL may be calculated as the contribution margin (sales - variable cost) divided by the excess of the contribution margin over fixed costs. The contribution margin is US \$150,000 [25,000 units x \$10 unit price - \$4 unit variable cost). Hence, the DOL in the second year is 1.50 [US \$150,000 CM ÷ \$150,000 - \$50,000 FC)].

**QUESTION: 24**

If an entity has a higher dividend-payout ratio, then, if all else is equal, it will have a

- A. Higher marginal cost of capital.
- B. Lower marginal cost of capital.
- C. Higher investment opportunity schedule.
- D. Lower investment opportunity schedule.

**Answer: A**

The higher the dividend-payout ratio, the sooner retained earnings are exhausted and the entity must seek external financing. Assuming the same investments are undertaken, the result is a higher marginal cost of capital because lower-cost capital sources will be used up earlier.

**QUESTION: 25**

If two entities, entity X and entity Y, are alike in all respects except that entity X employs more debt financing and less equity financing than entity Y does, which of the following statements is true?

- A. Entity X has more net earnings variability than entity Y.
- B. Entity X has more operating earnings variability than entity Y.
- C. Entity X has less operating earnings variability than entity Y.
- D. Entity X has less financial leverage than entity Y.

**Answer:** A

Given that entity X is more highly leveraged, it has greater fixed financing charges than entity Y. Interest payments are fixed financing charges, but ordinary share dividends are not. As a result, entity X will be more risky and therefore will have a more volatile net income stream than entity Y, if other factors are constant.

**QUESTION: 26**

The market value of an entity's outstanding ordinary shares will be higher, everything else equal, if investors

- A. Have a lower required return on equity.
- B. Expect lower dividend growth.
- C. Have longer expected holding periods.
- D. Have shorter expected holding periods.

**Answer:** A

The dividend growth model is used to calculate the cost of equity. The simplified formula is

$$R = \frac{D}{P} + G$$

R is the required rate of return, D is the next dividend, P is the share's price, and G is the growth rate in earnings per share. The equation is also used to determine the share price.

$$P = \frac{D}{R - G}$$

Thus, when investors have a lower required return on equity, the denominator is smaller, which translates into a higher market value.

**QUESTION: 27**

Assume that nominal interest rates just increased substantially but that the expected future dividends for an entity over the long run were not affected. As a result of the increase in nominal interest rates, the entity's share price should

- A. Increase.
- B. Decrease.
- C. Stay constant
- D. Change, but in no obvious direction\_

**Answer: B.**

The dividend growth model is used to calculate the price of a share.

$$P_0 = \frac{D_1}{R_s - G}$$

If:  $P_0$  = current price  
 $D_1$  = next dividend  
 $R_s$  = required rate of return  
 $G$  = EPS growth rate

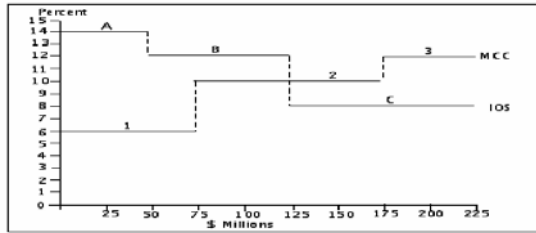
Assuming that  $D_1$  and  $G$  remain constant, an increase in  $R_s$  resulting from an increase in the nominal interest rate will cause  $P_0$  to decrease. A higher interest rate raises the required return of investors, which results in a lower share price. An entity has the following three investment projects available:

Project	Cost	Internal Rate of Return
A	US \$ 50 million	14%
B	US \$ 75 million	12%
C	US \$125 million	8%

The entity has a 40 % debt and 60 % equity capital structure. Each monetary unit of investment funds will be raised in these proportions (.40 of debt and .60 of equity). The marginal cost of financing increases with the amount of new funds raised, as follows:

Interval	Amount Raised	Weighted-Average Cost of Capital
1	First US \$ 75 million	6%
2	Next US \$100 million	10%
3	Over US \$175 million	12%

These investment opportunities and financing costs are shown in the graph below.



MCC=Marginal cost of capital

IOS=Investment opportunity schedule

**QUESTION: 28**

The investment opportunity schedule (IOS) shows, in rank order, how much money the entity would invest at different rates of return. Such schedules can be drawn only for a set of projects that

- A. Have the same investment cost.
- B. Are mutually exclusive.
- C. Have the same net present value.
- D. Are independent.

**Answer: D**

An IOS schedule is drawn for a set of independent projects. The decision to be made is whether to accept or reject each project without regard to other investment opportunities. Thus, the cash flows of one independent project are not influenced by those of another. Independence should be distinguished from mutual exclusivity. Projects are mutually exclusive if acceptance of one requires rejection of the other.

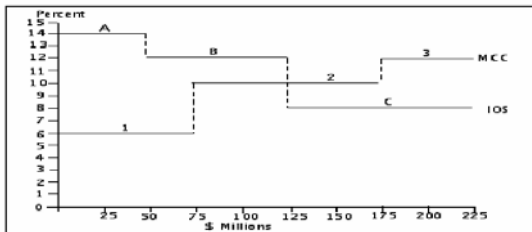
An entity has the following three investment projects available:

Project	Cost	Internal Rate of Return
A	US \$ 50 million	14%
B	US \$ 75 million	12%
C	US \$125 million	8%

The entity has a 40% debt and 60% equity capital structure. Each monetary unit of investment funds will be raised in these proportions (40% of debt and 60% of equity). The marginal cost of financing increases with the amount of new funds raised, as follows:

Interval	Amount Raised	Weighted-Average Cost of Capital
1	First US \$ 75 million	6%
2	Next US \$100 million	10%
3	Over US \$175 million	12%

These investment opportunities and financing costs are shown in the graph below.



MCC=Marginal cost of capital

IOS=Investment opportunity schedule

#### QUESTION: 29

The entity should invest in Project(s) <List A> and has an optimal capital budget of <List B> million.

	List A	List B
A.	B only	75
B.	A and B only	125
C.	A and C only	175
D.	C only	125

#### Answer: B.

The inf.-,reaction of the IOS and MCC schedules determines the cost of capital and the optimal capital budget. The entity should begin with the project having the highest return and continue accepting projects as long as the IRR the MCC. The highest ranked project is A, with a \$50 million cost and a 14% IRR. The MCC is only 6% over this range of financing. The next highest ranked project is B, with a US \$75 million cost and a 12% IRR. When US \$125 million has been invested, the marginal cost of the next unit of capital is 10%, so Project B. is also acceptable, bringing the optimal capital budget to US \$125 million. Project C is not acceptable because it has an 8% return. The MCC is 10% for the first US \$50 million invested in this project and 12% for the remaining US \$75 million.

#### QUESTION: 30

The marginal cost of debt for an entity is defined as the interest rate on <List A> debt

	List A	List B
A.	New	Entity's marginal tax rate
B.	Outstanding	Entity's marginal tax rate
C.	New	Interest rate times the entity's marginal tax rate
D.	Outstanding	Interest rate times the entity's marginal tax rate

minus

**Answer: C**

The marginal cost of debt as a rate) must equal the cost of new debt as a rate) minus the tax savings as a rate). Hence, marginal cost equals the cost of new debt times one minus the marginal tax rate, or  $k_s(1 - T)$ . This expression equals  $K_a - K_aT$ . The marginal cost of debt financing is the interest rate on new debt minus the entity's marginal tax rate multiplied by the interest rate. Moreover, the marginal or incremental cost of debt to the entity is based on the cost of newly issued debt, not on the cost of outstanding debt.

**QUESTION: 31**

An entity has 10,000 outstanding shares with a market value of US \$25 each. It just paid a US \$1 per share dividend. Dividends are expected to grow at a constant rate of 10%. If flotation costs are 5% of the selling price, the cost of new equity financing is calculated by the following formula.



$$\begin{aligned}
 \text{A. } & \frac{\text{Dividend at time zero}}{\text{Market price}} + \text{Dividend growth rate} \\
 &= (\text{US } \$1.10 \div \$25) + .10 \\
 &= .04 + .10 = 14.00\% \\
 \text{B. } & \frac{\text{Dividend at time zero}}{\text{Net proceeds}} + \text{Dividend growth rate} \\
 &= (\text{US } \$1 \div \$23.75) + .10 \\
 &= .0421 + .10 = 14.21\% \\
 \text{C. } & \frac{\text{Expected dividend at end of period}}{\text{Market price}} + \text{Dividend growth rate} \\
 &= (\text{US } \$1.10 \div \$25) + .10 \\
 &= .044 + .10 = 14.40\% \\
 \text{D. } & \frac{\text{Expected dividend at end of period}}{\text{Net proceeds issuing one share}} + \text{Dividend growth rate} \\
 &= [\text{US } \$1(1.1) \div \$23.75] + .10 \\
 &= .0463 + .10 = 14.63\%
 \end{aligned}$$

**Answer: C**

The cost of new equity is calculated by adding the expected dividend yield, based on the net proceeds of the new issue, to the expected dividend growth rate. The expected dividend at the end of the period equals the dividend at time zero times one plus the expected dividend growth rate. Net proceeds received by the entity when issuing one ordinary share equals the market price of a share times one minus the flotation cost percentage. Flotation costs include items such as underwriting fees, printing, and advertising. The calculation of the cost of new equity is as follows:

$$\begin{aligned}
 & \frac{\text{Expected dividend at end of period}}{\text{Net proceeds issuing one share}} + \text{Dividend growth rate} \\
 &= \frac{\text{US } \$1(1 + .10)}{\$25(1 - .05)} + 10\% \\
 &= 14.63\%
 \end{aligned}$$

### **QUESTION: 32**

An entity must select from among several methods of financing arrangements when meeting its capital requirements. To acquire additional growth capital while attempting to maximize earnings per share, an entity should normally

- A. Attempt to increase both debt and equity in equal proportions, which presents a stable capital structure and maintains investor confidence.
- B. Select debt over equity initially, even though increased debt is accompanied by interest costs and a degree of risk.
- C. Select equity over debt initially, which minimizes risk and avoids interest costs.
- D. Discontinue dividends and use current cash flow, which avoids the cost and risk of increased debt and the dilution of EPS through increased equity.

**Answer: B.**

Earnings per share will ordinarily be higher if debt is used to raise capital instead of equity, provided that the entity is not over-leveraged. The reason is that the cost of debt is lower than the cost of equity because interest is tax deductible. However, the prospect of higher EPS is accompanied by greater risk to the entity resulting from required interest costs, creditors' liens on the entity's assets, and the possibility of a proportionately lower EPS if sales volume fails to meet projections.

**QUESTION: 33**

The marginal cost of capital (MCC) curve for this entity rises twice, first when the entity has raised US \$75 million and again when US \$175 million of new funds has been raised. These increases in the MCC are caused by

- A. Increases in the returns on the additional investments undertaken.
- B. Decreases in the returns on the additional investments undertaken.
- C. Decreases in the cost of at least one of the financing sources.
- D. Increases in the cost of at least one of the financing sources.

**Answer: D**

The MCC is a weighted average of the costs of the different financing sources. If the cost of any source of financing increases, the MCC curve will rise. The MCC curve is upward sloping because the lowest cost financing sources are assumed to be used first. Thus, as cumulative debt increases, the cost of debt also increases. CyberAge Outlet, a relatively new store, is a cafe that offers customers the opportunity to browse the Internet or play computer games at their tables while they drink coffee. The customer pays a fee based on the amount of time spent signed on to the computer. The store also sells books, tee-shirts, and computer accessories. CyberAge has been paying all of its bills on the last day of the payment period, thus forfeiting all supplier discounts. Shown below are data on CyberAge's two major vendors, including average monthly purchases and credit terms.

<u>Vendor</u>	<u>Average Monthly Purchases</u>	<u>Credit Terms</u>
Web Master	US \$25,000	2/10, net 30
Softidee	50,000	5/10, net 90

**QUESTION: 34**

Assuming a 360-day year and that CyberAge continues paying on the last day of the credit period, the entity's weighted-average annual interest rate for trade credit ignoring the effects of compounding) for these two vendors is

- A. 27.0%
- B. 25.2%
- C. 28.0%
- D. 30.2%

**Answer: B.**

If the entity pays Web [...Taster within 10 days, it will save US \$500 (\$25,000 2%). Thus, the entity is effectively paying US \$500 to retain US \$24,500 (\$25,000 - \$500) for 20 days (30 - 10). The annualized interest rate on this borrowing is 36.7346%  $[(US \$500 + \$24,500) \times 360 \text{ days} \div 20 \text{ days}]$ . Similarly, the entity is, in effect, paying Softidee US \$2,500 (\$50,000 5%) to hold US \$47,500 (\$50,000 - \$2,500) for 80 days (90 - 10). The annualized rate on this borrowing is 23.6842%  $[(US \$2,500 + \$47,500) \times 360 \text{ days} \div 80 \text{ days}]$ . The average amount borrowed from Web Master is US \$16,333.33  $[(\$24,500 \times 1 \text{ month} \times 20 \text{ days}) \div 30 \text{ days}]$ . The average amount borrowed from web master is US \$126,666.67  $[(\$47,500 \times 3 \text{ months} \times 80 \text{ days}) \div 90 \text{ days}]$ . Thus, the weighted average of these two rates based on average borrowing is 25.2%  $[(\$16,333.33 \times 36.7346\%) + (\$126,666.67 \times 23.6824\%) \div \$16,333.33 + \$126,666.67]$ . This calculation however, understates the true cost of not taking the discount because it does not consider the effects of compound. CyberAge Outlet, a relatively new store, is a cafe that offers customers the opportunity to browse the Internet or play computer games at their tables while they drink coffee. The customer pays a fee based on the amount of time spent signed on to the computer. The store also sells books, tee-shirts, and computer accessories. CyberAge has been paying all of its bills on the last day of the payment period, thus forfeiting all supplier discounts. Shown below are data on CyberAge's two major vendors, including average monthly purchases and credit terms.

<u>Vendor</u>	<u>Average Monthly Purchases</u>	<u>Credit Terms</u>
Web Master	US \$25,000	2/10, net 30
Softidee	50,000	5/10, net 90

**QUESTION: 35**

Should CyberAge use trade credit and continue paying at the end of the credit period?

- A. Yes, if the cost of alternative short-term financing is less\_
- B. Yes, if the entity's weighted-average cost of capital is equal to its weighted-average cost of trade credit.
- C. No, if the cost of alternative long-term financing is greater.
- D. Yes, if the cost of alternative short-term financing is greater.

**Answer: D**

The entity is currently paying an annual rate of 25.2% as determined below) to obtain trade credit and pay at the end of the credit period. This policy should be continued if trade credit is the only source of financing, or if other sources are available only at a higher rate. The annual rate is determined as follows If the entity pays Web Master within 10 days. it will US \$500 2% X \$25,000). Thus the entity is effectively paying US \$500 to retain US \$24,500 \$25,000 – \$500) for 20 days 30 – 10). The annualized interest rate on this borrowing is 36.7346% [(US \$500 – \$24,500) x 360 days – 20 days)]. The annualized rate on this borrowing is 36,7346% [(US \$500 – \$24,500) x 360 days – 20 days)]. Similarly the entity 90 – 10). The annualized rate on this borrowing is 23,6842% [(US \$2,500 ÷ \$47,500 x 360 days ÷ 80 days)]. The average amount borrowed from Web Master is US \$16,333,33 [1 month x \$24,500 x 20 days ÷ 30 days)] and the average amount borrowed from Softidee is US \$125,666,67 [3 months x \$47,500 x 80 days ÷ 90 days)]. Thus, the weighted average of these two rates based on average borrowings is 25.2% {(36.7346% x US \$16,333,33) + 23,6842% x \$126,666.67)]. ÷ \$16,333,33) + (23.6842% \$126,666,66}] ÷ \$16,333,33 + \$126,666,67)].

**QUESTION: 36**

A measure that describes the risk of an investment project relative to other investments in general is the

- A. Coefficient of variation.
- B. Beta coefficient
- C. Standard deviation.
- D. Expected return

**Answer: B.**

The required rate of return on equity capital in the Capital Asset Pricing Model is the risk-free rate, plus the product of the market risk premium times the beta coefficient. The market risk premium is the amount above the risk-free rate that will induce investment in the market The beta coefficient of an individual share is the correlation between the volatility price variation) of the stock market and that of the price of the individual share. For example. if an individual share goes up 15% and the market only 10%. beta is 1.5.

**QUESTION: 37**

The difference between the required rate of return on a given risky investment and that of a risk-free investment with the same expected return is the

- A. Risk premium.
- B. Coefficient of variation.
- C Standard error of measurement.
- D. Beta coefficient

**Answer: A**

The market risk premium  $R_M - R_F$ ) is the amount above the risk-free rate required to include average investors to enter the market. The risk premium is the portion of expected return attributed to the increased risk.

**QUESTION: 38**

Capital structure decisions involve determining the proportions of financing from

- A Short-term or long-term debt
- B. Debt or equity.
- C. Short-term or long-term assets.
- D. Retained earnings or ordinary stock.

**Answer: B.**

The optimal capital structure minimizes the weighted average cost of capital and thereby maximizes the value of the entity's stock. Both debt and equity are factors in an entity's capital structure.

**QUESTION: 39**

If a high percentage of an entity's total costs is fixed, the entity's operating leverage will be

- A. High.
- B. Low.
- C. Unchanged.
- D Unable to be determined

**Answer: A**

In business terminology, a high degree of operating leverage, other things held constant, means that a relatively small change in sales will result in a large change in operating income. Therefore, if a high percentage of an entity's total cost is fixed, the entity is said to have a high degree of operating leverage.

**QUESTION: 40**

When comparing two companies, if all else is equal, the entity that has a higher dividend payout ratio will have a

- A. Higher marginal cost of capital.
- B. Lower debt ratio.
- C. Higher investment opportunity schedule.
- D. Higher price to earnings ratio.

**Answer: A**

The higher the dividend payout ratio, the sooner retained earnings are exhausted and the entity must seek more costly, outside equity financing. This drives the marginal cost of capital.

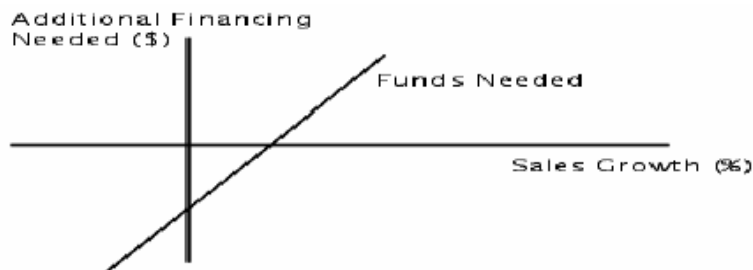
**QUESTION: 41**

The efficient markets theory implies that securities prices are

- A. Not a good estimate of future cash flows.
- B. Fair and a reflection of all publicly available information.
- C. Not the best benchmark for corporate financial decisions
- D. Always less than their fair value.

**Answer: B**

The efficient markets theory proposes that the market is continuously adjusting to new information and acting to correct pricing errors.



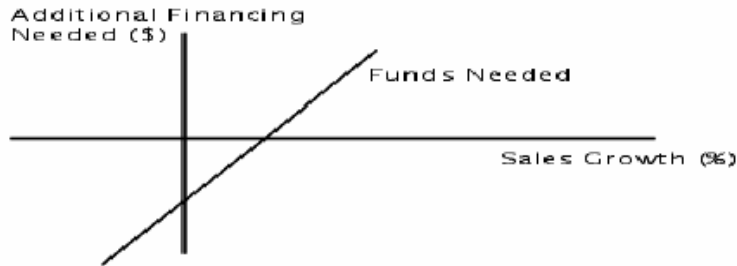
**QUESTION: 42**

The funds-needed line does not pass through the origin unless the entity has a

- A. One-hundred percent dividend payout policy\_
- B. Zero percent dividend payout policy\_
- C. One-hundred percent sales growth rate.
- D. Zero percent sales growth rate.

**Answer: A**

If all earnings are paid out as dividends, then there is no earnings retention. All sales growth must be financed from spontaneous or external sources

**QUESTION: 43**

If all else is equal, entities with higher profit margins require less additional financing for any sales growth rate. If the profit margin of an entity increased, the funds-needed line would shift

- A. Up and become less steep
- B. Up and become more steep
- C. Down and become less steep.
- D. Down and become more steep.

**Answer: C**

A higher profit margin would reduce the additional financing needed, shifting the funds needed line down.

**QUESTION: 44**

The economic value of an entity will rise following an increase in

- A Net cash flow.

- B. Systematic risk.
- C. Unsystematic risk.
- D. The discount rate.

**Answer:** A

Net cash flow represents the numerator in the formula used to derive the value of the entity. Therefore, the economic value of the entity will increase as net cash flow increases. Presented below are partial year-end financial statement data for entities.

	A	B
Cash	US \$100	US \$200
Accounts receivable	unknown	100
Inventories	unknown	100
Net fixed assets	200	100
Accounts payable	100	50
Long-term debt	200	50
Ordinary shares	100	200
Retained earnings	150	100
	A	B
Sales	US \$600	US \$5,800
Cost of goods sold	300	5,000
Administrative expenses	100	500
Depreciation expense	100	100
Interest expense	20	10
Income tax expense	40	95
Profit	40	95

**QUESTION:** 45

The degree of financial leverage of B, to two decimal places, is

- A. 1.03
- B. 1.05
- C. 1.2
- D. 1.25

**Answer:** B.

The degree of financial leverage for B. may be calculated as profit before interest and taxes (PBIT), divided by PBIT minus interest. PBIT is 200 95 profit 10 interest 95 tax expense). Thus, the DFL is 1.05  $[200 - 200 - 10]$ .

**QUESTION:** 46

All other things held constant, external capital requirements are lower for entities with which one of the following characteristics?

- A. Lower retention ratios\_
- B. Higher sales growth rates.
- C. Lower capital intensity ratios.



D. Lower profit margins.

**Answer: C**

The capital intensity ratio is the amount of assets required per dollar of sales. External financial requirements are lower if the capital intensity ratio is low because sales can grow rapidly without much outside capital, other things held constant.

**QUESTION: 47**

The most direct way to prepare a cash budget for a manufacturing entity is to include

- A. Projected sales, credit terms, and net income.
- B. Projected net income, depreciation, and goodwill amortization.
- C. Projected purchases, percentages of purchases paid, and net income.
- D. Projected sales and purchases, percentages of collections, and terms of payments.

**Answer: D**

The most direct way of preparing a cash budget requires incorporation of sales projections and credit terms. collection percentages, estimated purchases and payment terms, and other cash receipts and disbursements. In other words, preparation of the cash budget requires consideration of both inflows and outflows.

**QUESTION: 48**

An entity has a majority of its customers located in states A and B. A major west coast bank has agreed to provide a lockbox system to the entity at a fixed fee of US \$50,000 per year and a variable fee of US \$0.50 for each payment processed by the bank. On average, the entity receives 50 payments per day, each averaging US \$20,000. With the lockbox system, the entity's collection float will decrease by 2 days. The annual interest rate on money market securities is 6%. If the entity makes use of the lockbox system, what would be the net benefit to the entity? Use 365 days per year.

- A. US \$55,125
- B. US \$60,875
- C. US \$50,000
- D. US \$120,000

**Answer: B.**

If payments are collected 2 days earlier, the entity can earn US \$120,000  $20,000 \times 50$  payments per day  $2 \text{ days} \times .06$  at a cost of US \$59,125  $[\$50,000 + 50 \text{ payments} \times 365 \text{ days} \times \$0.50]$ , a gain of US \$60,875.

**QUESTION: 49**

A retail mail order entity currently uses a central collection system that requires all checks to be sent to its headquarters. An average of 6 days is required for mailed checks to be received, 3 days for the entity to process them, and 2 days for the checks to clear through the bank. A proposed lockbox system would reduce the mailing and processing time to 2 days and the check clearing time to 1 day. The entity has an average daily collection of US \$150,000. How much will the average cash balance increase by if the entity adopts the lockbox system?

- A. US \$1,200,000
- B. US \$750,000
- C. US \$600,000
- D. US \$450,000

**Answer: A**

Checks are currently tied up for 11 days (6 for mailing, 3 for processing, and 2 for clearing). If that period were reduced to 3 days, the entity's cash balance would increase by US \$1,200,000 (\$150,000 per day x 8 days).

**QUESTION: 50**

Assume that each day an entity writes and receives checks totaling US \$10,000. If it takes 5 days for the checks to clear and be deducted from the entity's account and only 4 days for the deposits to clear, what is the float?

- A. US \$10,000
- B. US \$0
- C. US \$(10,000)
- D. US \$50,000

**Answer: A**

The float period is the time between when a check is written and when it clears the payer's checking account. Check float results in an interest-free loan to the payer because of the delay between payment by check and its deduction from the bank account. If checks written require one more day to clear than checks received, the net float equals one day's receipts. The entity will have free use of the money for one day. In this case, the amount is US \$10,000.

**QUESTION: 51**

An entity obtained a short-term bank loan of US \$250,000 at an annual interest rate of 6%. As a condition of the loan, the entity is required to maintain a compensating balance of US \$50,000 in its checking account. The entity's checking account earns interest at an annual rate of 2 %. Ordinarily, the entity maintains a balance of US \$25,000 in its checking account for transaction purposes. What is the effective interest rate of the loan?

- A. 6.44%
- B. 7.00%
- C. 5.80%
- D. 6.66%

**Answer: A**

The US \$50,000 compensating balance requirement is partially satisfied by the entity's practice of maintaining a US \$25,000 balance for transaction purposes. Thus, only US \$25,000 of the loan will not be available for current use, leaving US \$225,000 of the loan usable. At 6% interest, the US \$250,000 loan would require an interest payment of US \$15,000 per year. This is partially offset by the 2% interest earned on the US \$25,000 incremental balance, or US \$500. Subtracting the US \$500 interest earned from the US \$15,000 of expense results in net interest expense of US \$14,500 for the use of US \$225,000 in funds. Dividing US \$14,500 by US \$225,000 produces an effective interest rate of 6.44%.

**QUESTION: 52**

Which one of the following is not a characteristic of a negotiable certificate of deposit?  
Negotiable certificates of deposit

- A. Have a secondary market for investors.
- B. Are regulated by the government
- C. Are usually sold in denominations of a minimum of US \$100,000.
- D. Have yields considerably greater than bankers' acceptances and commercial paper.

**Answer: D**

A certificate of deposit (CD) is a form of savings deposit that cannot be withdrawn before maturity without incurring a high penalty. A negotiable CD can be traded. CDs usually have a fairly high rate of return compared with other savings instruments because they are for fixed, usually long-term periods.

**QUESTION: 53**

An entity has daily cash receipts of US \$300,000. A bank has offered to provide a lockbox service that will reduce the collection time by 3 days. The bank requires a

monthly fee of US \$2,000 for providing this service. If money market rates are expected to average 6% during the year, the additional annual income loss) of using the lockbox service is

- A. US \$(24,000)
- B. US \$12,000
- C. US \$30,000
- D. US \$54,000

**Answer: C**

Because collections will be accelerated by 3 days at a rate of US \$300,000 per days, the entity will have an additional US \$900,000 to invest. At a rate of 6%, the interest earned will be US \$54,000 per year. However, the bank will charge US \$24,000 (\$2,000 per month x 12 months) for its services. Thus, the entity will increase its income by US \$30,000 (\$54,000 - \$24,000).

**QUESTION: 54**

An entity uses the following formula in determining its optimal level of cash.

$$OC = \sqrt{\frac{2bT}{i}}$$

If: b = fixed cost per transaction  
 T = total demand for cash over a period of time  
 i = interest rate on marketable securities

This formula is a modification of the economic order quantity (EOQ) formula used for inventory management. Assume that the cost of selling marketable securities is US \$10 per transaction and the interest rate on marketable securities is 6% per year. The entity estimates that it will make cash payments of US \$12,000 over a one-month period. What is the average cash balance rounded to the nearest dollar)?

- A. US \$1,000
- B. US \$2,000
- C. US \$3,464
- D. US \$6,928

**Answer: C**

The BOO for inventory is a function of ordering cost per order, inventory demand, and carrying cost. In the cash model, the fixed cost per sale of securities is equivalent to the ordering cost, the demand for cash is similar to the demand for inventory, and the interest

rate is effectively the cost of carrying a dollar of cash for the period. Substituting in the formula yields an optimal cash balance of about US \$6,928. Thus, the average cash balance is US \$3,464 (\$6,928 - 2).

$$\sqrt{\frac{2bT}{i}} = \sqrt{\frac{2 \times \text{US } \$10 \times \$12,000}{6\% \div 12 \text{ months}}} = \sqrt{\frac{\text{US } \$240,000}{.005}} = \text{US } \$6,928$$

**QUESTION: 55**

An entity has daily cash receipts of US \$100,000 and collection time of 2 days. A bank has offered to reduce the collection time on the entity's deposits by 2 days for a monthly fee of US \$500. If money market rates are expected to average 6% during the year, the net annual benefit (loss) from having this service is

- A. US \$3,000
- B. US \$12,000
- C. US \$0
- D. US \$6,000

**Answer: D**

If collection time is 2 days, and average daily receipts are US \$ 100,000, the average cash balance will increase by I. \$200,000 if the bank's system is adopted. At a 6% interest rate, US \$200,000 will generate US \$12,000 of interest revenue annually. The US \$500 monthly charge by the bank will result in an annual expense of US \$6,000. Thus, the net annual benefit is US \$6,000 (\$12,000 - \$6,000).

**QUESTION: 56**

The owner of a newly established janitorial entity is deciding what type of checking to open. The entity is planning to keep a US \$500 minimum balance in the account for emergencies and plans to write roughly 80 checks per month. The bank charges US \$10 per month plus a US \$0.10 per check charge for a standard business checking account with no minimum balance. The entity also has the option of a premium business checking account that requires a US \$2,500 minimum balance but has no monthly fees or per check charges. If the entity's cost of funds is 10%, which account should the entity choose?

- A. Standard account, because the savings is US \$34 per year.
- B. Premium account, because the savings is US \$34 per year.
- C. Standard account, because the savings is US \$16 per year.
- D. Premium account, because the savings is US \$16 per year.

**Answer: D**

The standard account will cost US \$10 per month plus US \$8 in check charges  $$.10 \times 80$  checks), for a total of US \$18 per month US \$216 per year). The premium account has no check charges. but it will require the depositor to maintain a balance of US \$2,000 more than desired. At a 10% cost of capital, the incremental US \$2,000 minimum deposit will cost US \$200 per year. Thus, the premium account should be selected because it is cheaper by US \$16 per year.

**QUESTION: 57**

A corporation has received proposals from several banks to establish a lockbox system to speed up receipts. The corporation receives an average of 700 checks per day averaging US \$1,800 each, and its cost of short-term funds is 7% per year. Assuming that all proposals will produce equivalent processing results and using a 360-day year, which one of the following proposals is optimal for the corporation?

- A A US \$0.50 fee per check.
- B. A flat fee of US \$125,000 per year.
- C. A fee of 0.03% of the amount collected.
- D. A compensating balance of US \$1,750,000.

**Answer: D**

Multiplying 700 checks by 360 days results in a total of US \$252,000 checks per year. Accordingly, at a US \$0.50 fee per check, total annual cost is US \$126,000  $$.50 \times 252,000$ ), which is less desirable than the US \$125,000 flat fee. Given that the annual collections equal US \$453,600,000  $\$1,800 \times 700 \times 360$ ), a fee of 0.03% of the amount collected is also less desirable because the annual fee would be US \$136,080  $.03\% \times \$453,600,000$ ). The best option is therefore to maintain a compensating balance of US \$1,750,000 when the cost of funds is 7%, resulting in a total cost of US \$122,500  $.07 \times \$1,750,000$ ).

**QUESTION: 58**

An entity has daily cash receipts of US \$300,000 and is interested in acquiring a lockbox service in order to reduce collection time. Bank 1's lockbox service cost US \$3,000 per month and will reduce collection time by 3 days. Bank 2's lockbox service costs US \$5,000 per month and will reduce collection time by 4 days. Bank 3's lockbox service cost US \$500 per month and will reduce collection time by 4 days. Bank 2's lockbox service costs US \$500 per month and will reduce collection time by 4 days. Bank 3's lockbox service cost US \$500 per month and will reduce collection time by 4 days. Bank 4's lockbox service cost US \$1,000 per month and will reduce collection time by 2 days. If money market rates are expected to average 6% during the year, and the entity wishes

to maximize income, which bank should the entity choose?

- A. Bank 1.
- B. Bank 2
- C. Bank 3
- D. Bank 4

**Answer: D**

Because collections made using Bank 4's lockbox service will be accelerated by 2 days at a rate of US \$300,000 per day, the entity will have an additional US \$600,000 to invest. At a rate of 6%, the interest earned will be US \$36,000 per year. However, the bank will charge US \$12,000 (12 months x \$1,000 per month) for its services. Thus, the entity will gain US \$24,000 (\$36,000 - \$12,000).

**QUESTION: 59**

Company A is a retailer operating in several cities. The individual store managers deposit daily collections at a local bank in a non-interest bearing checking account. Twice per week, the local bank issues a depository transfer check (DTC) to the central bank at headquarters. The controller of the company is considering using a wire transfer instead. The additional cost of each transfer would be US \$25. Collections would be accelerated by 2 days, and the annual interest rate paid by the central bank is 7.2% (0.02% per day). At what amount of dollars transferred would it be economically feasible to use a wire transfer instead of the DTC? Assume a 360-day year.

- A. It would never be economically feasible.
- B. US \$125,000 or above.
- C. Any amount greater than US \$173.
- D. Any amount greater than US \$62,500.

**Answer: D**

Given a US \$25 fee and an interest rate of 0.02% per day for 2 days, the breakeven amount is US \$62,500 [\$25 transfer fee ÷ 2 x .02% interest rate]. Thus, the interest earned on a transfer of any amount greater than US \$62,500 would exceed the US \$25 fee.

**QUESTION: 60**

A working capital technique that increases the payable float and therefore delays the outflow of cash is

- A. Concentration banking.

- B. A draft.
- C. Electronic Data Interchange EDO.
- D. A lockbox system.

**Answer:** B.

Payment by draft, a three-parry instrument in which the drawer orders the drawer to pay money to the payee, is a means of slowing cash outflows A check is the most common type of draft. Check float arises from the delay between an expenditure and the clearing of the check through the banking system.

**QUESTION:** 61

A compensating balance

- A. Compensates a financial institution for services rendered by providing it with deposits of funds.
- B. Is used to compensate for possible losses on a marketable securities portfolio.
- C. Is a level of inventory held to compensate for variations in usage rate and lead time.
- D. Is the amount of prepaid interest on a loan.

**Answer:** A

Banks sometimes require a borrower to keep a certain percentage of the face amount of a loan in a noni nterest-bearing checking account. This requirement raises the effective rate of interest paid by the borrower. This greater rate compensates a bank for services provided and results in greater profitability for the financial institution. Funds kept as a compensating balance can often be withdrawn if a certain average balance is maintained.

**QUESTION:** 62

Company B's bank requires a compensating balance of 20% on a US \$100.000 loan. If the stated interest on the loan is 7%, what is the effective cost of the loan?

- A. 5.83%
- B. 7.00%
- C 8.40%
- D 8.75%

**Answer:** D

Interest on the loan is US \$7,000  $7\% \times \$100,000$ ) Given that the borrower has to maintain a 20% compensating balance, only US \$80,000  $[\$100,000 - 20\% \times 100,000]$  is available for use. Thus. the company is paying US \$7.000 for the use of US \$80.01 ii a in funds at



an effective cost of 8.75% US.  $\$7,000 \div 80,000$ ).

**QUESTION: 63**

Which of the following models is essentially an application to cash management of the inventory economic order quantity (EOQ) formula?

- A. Miller-Orr cash management model.
- B. Baumol cash management model.
- C. Altman's Z-Score model.
- D. Arbitrage pricing model.

**Answer: B.**

The Baumol cash management model is essentially the inventory EOQ model in that it minimizes the total of fixed trading costs and cash carrying costs. It is a deterministic model in the same way that the EOQ model is deterministic.

**QUESTION: 64**

All of the following are alternative marketable securities suitable for investment except

- A. U.S. Treasury bills.
- B. Eurodollars.
- C. Commercial paper.
- D. Convertible bonds.

**Answer: D**

Marketable securities are near-cash items used primarily for short-term investment. Examples include U.S. Treasury bills, Eurodollars, commercial paper, money-market mutual funds with portfolios of short-term securities, bankers' acceptances, floating rate preference stock, and negotiable CDs of U.S. banks. A convertible bond is not a short-term investment because its maturity date is usually more than one year in the future and its price can be influenced substantially by changes in interest rates or by changes in the investee's stock price.

**QUESTION: 65**

Why would an entity maintain a compensating cash balance?

- A. To make routine payments and collections.
- B. To pay for banking services.

- C. To provide a reserve in case of unforeseen fluctuations in cash flows.
- D. To take advantage of bargain purchase opportunities that may arise.

**Answer:** B.

The compensating cash balance is the money left in a checking account in the bank in order to compensate the bank for services it provides.

**QUESTION:** 66

The treasury analyst for a manufacturing entity has estimated the cash flows for the first half of next year (ignoring any short-term borrowings) as follows:

	Cash (millions)	
	Inflows	Outflows
January	US \$2	US \$1
February	2	4
March	2	5
April	2	3
May	4	2
June	5	3

The entity has a line of credit of up to US \$4 million on which it pays interest monthly at a rate of 1% of the amount used. The entity is expected to have a cash balance of US \$2 million on January 1, with no amount of its line of credit used. Assuming all cash flows occur at the end of the month, approximately how much will the entity pay in interest during the first half of the year?

- A. 0
- B. US \$61,000
- C. US \$80,000
- D. US \$132,000

**Answer:** B.

The sum of the beginning balance and inflows exceeds the outflows for the first 2 months. At the end of March, however, the entity must use US \$2,000,000 of its line of credit (US \$2,000,000 beginning balance \$6,000,000 inflows - \$10,000,000 outflows). Thus, interest for April is US \$20,000 (1% x \$2,000,000). The net cash outflow for April (ignoring short-term borrowings) is US \$1,000,000 of an additional US \$1,000,000 of the line of credit. However, the US \$20,000 of interest for April must also be paid, so the amount of the line of credit used in May is US \$3,020,000 (\$2,000,000 + \$1,000,000 + \$20,000). Interest for May is therefore US \$30,200 (1% \$3,020,000). The net cash inflow for May of US \$2,000,000 (again ignoring short-term borrowings) and the borrowing of US \$30,200 to pay the interest for May, the amount of the line of credit used in June is US \$1,050,200. Interest in June is US \$10,502 (1% \$1,050,200), and total interest is US \$60,702 (\$20,000 + \$30,200 + \$10,502). Consequently, the closest answer is

US \$61.000.

**QUESTION: 67**

The following information applies to an entity. Purchases Sales

	<u>Purchases</u>	<u>Sales</u>
January	US \$160,000	US \$100,000
February	160,000	200,000
March	160,000	240,000
April	140,000	300,000
May	140,000	260,000
June	120,000	240,000

A cash payment equal to 40% of purchases is made at the time of purchase, and 30% is paid in each of the next 2 months. Purchases for the previous November and December were US \$150,000 per month. Payroll is 10% of sales in the month it occurs, and operation expenses are 20% of the following month's sales July sales were US \$220,000). Interest payments were US \$20,000 paid quarterly in January and April. What were the entity's cash disbursements for the month of April?

- A. US \$140,000
- B. US \$152,000
- C. US \$200,000
- D. US \$254,000

**Answer: D**

The cash disbursements for the month of April include 40% of April purchases, 30% of March purchases, 30% of February purchases, April payroll 10% of April sales), operating expenses 20% of May sales), and an interest payment of US \$20,000.

40% × US \$140,000	=	US \$ 56,000
30% × US \$160,000	=	48,000
30% × US \$160,000	=	48,000
10% × US \$300,000	=	30,000
20% × US \$260,000	=	52,000
Interest	=	20,000
Total disbursements	=	<u>US \$254,000</u>

**QUESTION: 68**

Shown below is a forecast of sales for the first 4 months of the year all amounts are in thousands of dollars).

	January	February	March	April
Cash sales	US \$ 15	US \$ 24	US \$18	US \$14
Sales on credit	100	120	90	70

On average, 50% of credit sales are paid for in the month of sale, 30% in the month following the sale, and the remainder is paid 2 months after the month of sale. Assuming there are no bad debts, what is the expected cash inflow in March?

- A. US \$138,000
- B. US \$122,000
- C. US \$119,000
- D. US \$108,000

**Answer:** D

Cash inflows for March would consist of 50% of March credit sales US \$90 x 50% = US \$45). plus 30% of February credit sales US \$120 x 30% = US \$36). plus 20% of January credit sales US \$ 11-11. 20% = US \$20). plus cash sales for March of US \$18. Consequently, total collections equal US \$1 18,000.

**QUESTION:** 69

When managing cash and short-term investments, a corporate treasurer is primarily concerned with

- A. Maximizing rate of return.
- B. Minimizing taxes.
- C Investing in government bonds since they have no default risk.
- D Liquidity and safety.

**Answer:** D

Cash and short-term investments are crucial to an entity's continuing success. Sufficient liquidity must be available to meet payments as they come due. At the same time, liquid assets are subject to significant control risk. Therefore, liquidity and safety are the primary concerns of the treasurer when dealing with highly liquid assets. Cash and short-term investments are held because of their ability to facilitate routine operations of the entity. These assets are not held for purposes of achieving investment returns.

**QUESTION:** 70

Which of the following financial instruments can be traded in international money markets?

- A. Mortgages.
- B. Preference shares.
- C. U.S. Treasury bills.
- D. U.S. Treasury bonds.

**Answer: C**

Funds are borrowed or lent for short periods (less than one year) in money markets. Examples of instruments traded in money markets are U.S. Treasury bills, bankers' acceptances, commercial paper, negotiable certificates of deposit, money market mutual funds, Eurodollar market time deposits, and consumer, credit loans. Capital markets trade shares and long-term debt.

**QUESTION: 71**

The average collection period for an entity measures the number of days

- A. After a typical credit sale is made until the entity receives the payment.
- B. For a typical check to "clear" through the banking system.
- C. Beyond the end of the credit period before a typical customer payment is received.
- D. Before a typical account becomes delinquent.

**Answer: A**

The average collection period measures the number of days between the date of sale and the date of collection. It should be related to an entity's credit terms. For example, an entity that allows terms of 2/15, net 30, should have an average collection period of somewhere between 15 and 30 days.

**QUESTION: 72**

An entity averages inventory of US \$4,000 in sales per day and is paid on an average within 30 days of the sale. After they receive their invoice, 55% of the customers pay by check, while the remaining 45% pay by credit card. Approximately how much would the entity show in accounts receivable on its balance sheet on any given date?

- A. US \$4,000
- B. US \$120,000
- C. US \$48,000
- D. US \$54,000

**Answer: B.** If sales are US \$400 per day, and customers pay in 30 days. 30 days of sales are outstanding, or US \$120,000. Whether customers pay by credit card or cash

collection requires 30 days.

**QUESTION: 73**

If the average age of inventory is 60 days, the average age of the accounts payable is 30 days, and the average age of accounts receivable is 45 days, the number of days in the cash flow cycle is

- A. 135 days.
- B. 90 days.
- C. 75 days.
- D. 105 days.

**Answer: C**

The cash flow cycle begins when the entity pays for merchandise it has purchased and ends when the entity receives cash from the sale of the merchandise. Inventory is held for an average of 60 days prior to sale, but the average age of accounts payable is 30 days. Consequently, the average time between outlay and sale is 30 days. Receivables are collected an average of 45 days after sale, so the length of the cash flow cycle is 75 days (30 + 45).

**QUESTION: 74**

An entity sells to retail stores on credit terms of 2/10 net 30. Daily sales average 150 units at a price of US \$300 each. Assuming that all sales are on credit and 60% of customers take the discount and pay on day 10 while the rest of the customers pay on day 30, what is the amount of the entity's accounts receivable?

- A. US \$1,350,00
- B. US \$990,000
- C. US \$900,000
- D. US \$810,00

**Answer: D**

The entity has daily sales of US \$45,000 consisting of 150 units at US \$300 each. For 30 days, sales total US \$1,350,000. Forty percent of these sales, or US \$540,000, will be uncollected because customers do not take their discounts. The remaining 60%, or US \$810,000, will be paid within the discount period. However, by the end of 30 days, only 213 of the US \$810,000 will be collected because the sales from days 21 through 30 are still within the discount period. Therefore, an additional US \$270,000 (\$810,000 - \$540,000) will still be uncollected after the 30th day, but will be subject to a discount. In total, the average rep ~atl~~ balance is US \$810,000, consisting of US \$540,000 on

which no discount will be taken and US '1.270.000 that will be paid within the discount period.

**QUESTION: 75**

A change in credit policy has caused an increase in sales, an increase in discounts taken, a decrease in the amount of bad debts, and a decrease in the investment in accounts receivable. Based upon this information, the entity's

- A. Average collection period has decreased.
- B. Percentage discount offered has decreased.
- C. Accounts receivable turnover has decreased.
- D. Working capital has increased.

**Answer: A**

An increase in discounts taken accompanied by declines in receivables balances and doubtful accounts all indicate that collections on the increased sales have been accelerated. Accordingly, the average collection period must have declined. The average collection period is a ratio calculated by dividing the number of days in a year (365) by the receivable turnover. Thus, the higher the turnover, the shorter the average collection period. The turnover increases when either sales (the numerator) increase, or receivables (the denominator) decrease. Accomplishing both higher sales and a lower receivables increases the turnover and results in a shorter collection period.

**QUESTION: 76**

An entity plans to tighten its credit policy. The new policy will decrease the average number of days in collection from 75 to 50 days and will reduce the ratio of credit sales to total revenue from 70% to 60%. The entity estimates that projected sales will be 5% less if the proposed new credit policy is implemented. If projected sales for the coming year are US \$50 million, calculate the dollar impact on accounts receivable of this proposed change in credit policy. Assume a 360-day year.

- A. US \$3,817,445 decrease.
- B. US \$6,500,000 decrease.
- C. US \$3,333,334 decrease.
- D. US \$18,749,778 increase.

**Answer: C**

If sales are US \$50 million, 70% of which are on credit, total credit sales will be US \$35 million. The receivables turnover equals 4.8 times per year (360 days - 75-day collection period). Receivables turnover equals net credit sales divided by average

receivables. Accordingly, average receivables equal US \$7,291.667 (\$35,000,000 - 4.8). Under the new policy, sales will be US \$47.5 million (95% x \$50,000,000), and credit sales will be US \$28.5 million (60% x \$47,500,000). The collection period will be reduced to 50 days, resulting in a turnover of 7.2 times per year (360 - 50). The average receivables balance will therefore be US \$3,958,333 (\$28,500,000 - 7.2), a reduction of US \$3,333,334 (\$7,291.667 - \$3,958,333).

**QUESTION: 77**

Which of the following represents an entity's average gross receivables balance?

- I. Days' sales in receivables x accounts receivable turnover.
- II. Average daily sales x average collection period.
- III. Net sales/average gross receivables.

- A. I only.
- B. I and II only.
- C. II only.
- D. II and III only.

**Answer: C**

An entity's average gross receivables balance can be calculated by multiplying average daily sales by the average collection period (days' sales outstanding). Alternatively, annual credit sales can be divided by the accounts-receivable turnover (net credit sales/average accounts receivable) to obtain the average balance in receivables.

**QUESTION: 78**

The high cost of short-term financing has recently caused an entity to reevaluate the terms of credit it extends to its customers. The current policy is 1/10, net 60. If customers can borrow at the prime rate, at what prime rate must the entity change its terms of credit in order to avoid an undesirable extension in its collection of receivables?

- A. 2%
- B. 5%
- C. 7%
- D. 8%

**Answer: D**

Terms of 1/10, net 60 mean that a buyer can save 1% of the purchase price by paying 50 days early. In essence, not taking the discount results in the buyer's borrowing 99% of the invoice price for 50 days at a total interest charge of 1% of the invoice price. Because a year has 7.3 50-day periods (365 / 50), the credit terms 1/10, net 60 yield an effective



annualized interest charge of approximately 7.371 [(1% 99%) 7.3]. If the prime rate were higher than 7.37%, the buyer would prefer to borrow from the vendor i.e., not pay within the discount period) rather than from a bank. Consequently, an 8% prime rate could cause the vendor's receivables to increase. An entity sells 10,000 skateboards a year at US \$66 each. All sales are on credit, with terms of 3/10. net 30, which means three percent discount if percent it is made within 10 days; otherwise full payment is due at the end of 30 days. One half of the customers are expected to take advantage of the discount and pay on day 10. The other half are expected to pay on day 30. Sales are uniform throughout the year for both types of customers.

**QUESTION: 79**

What is the expected average collection period for the entity?

- A. 10 days
- B. 15 days
- C. 20 days.
- D. 30 days.

**Answer: C**

The average collection period is the average time it takes to receive payment from customers. because one-half of the customers will pay on day 10 and half will pay on day 30, the average collection period is 20 days  $[(.5(10 \text{ days}) + .5(30 \text{ days}))]$ . An entity sells 10,000 skateboards a year at US \$66 each. All sales are on credit, with terms of 3/10, net 30, which means three percent discount if payment is made within 10 days; otherwise full payment is due at the end of 30 days. One half of the customers are expected to take advantage of the discount and pay on day 10. The other half are expected to pay on day 30. Sales are expected to be uniform throughout the year for both types of customers.

**QUESTION: 80**

Assume that the average collection period is 25 days. After the credit policy is well established. what is the expected average accounts receivable balance for the entity at any moment in time, assuming a 365-day year?

- A. US \$684.93
- B. US \$1,808.22
- C. US \$27,123.30
- D. US \$45,205.48

**Answer: D**

The expected average accounts receivable balance equals the average collection period

times the credit sales per day. Thus, the average accounts receivable balance is US \$45,205.48  $\{[(10,000 \text{ units sold on credit} \times \$66 \text{ price}) - 365 \text{ days}] \times 25 \text{ days}\}$ . The foregoing calculation assumes that receivables are recorded at their gross amounts.

**QUESTION: 81**

A common mistake in valuing the entity to be acquired in a business combination is

- A Using market values in the valuation.
- B. Including incremental cash flows in the valuation.
- C. Using the acquirer's discount rate when valuing the incremental cash flows.
- D. Including all related transaction costs associated with an acquisition.

**Answer: C**

If the net incremental cash flows to the acquirer's shareholders are to be valued, the discount rate used should be the cost of equity capital. Moreover, this rate should reflect the risk associated with the use of funds rather than their source. The rate therefore should not be the cost of capital of the acquirer but rather the cost of equity of the combined entity after the combination. This calculation requires a new estimate of beta to be used in the Capital Asset Pricing Model.

**QUESTION: 82**

The appropriate discount rate to use in valuing a business combination is the

- A. Combined entity's cost of debt.
- B. Acquirer's weighted average cost of capital.
- C Acquirer's cost of equity.
- D Combined entity's cost of equity.

**Answer: D**

If the not incremental cash flows to the acquirer's shareholders are to be calculated, the discount rate used should be the cost of equity capital. Moreover, this rate should reflect the risk associated with the use of funds rather than their source. The rate therefore should not be the cost of capital of the acquirer but rather the cost of equity of the acquire after the combination. This calculation requires a new estimate of beta to be used in the Capital Asset Pricing Model.

**QUESTION: 83**

An entity has recently purchased some stock of a competitor as part of a long-term plan to acquire the competitor. However, it is somewhat concerned that the market price of

this stock could decrease over the short run. The entity could hedge against the possible decline in the stock's market price by

- A. Purchasing a call option on that stock.
- B. Purchasing a put option on that stock.
- C Selling a put option on that stock.
- D Obtaining a warrant option on that stock.

**Answer:** B.

A put option is the right to sell stock at a given price within a certain period. If the market price falls, the put option may allow the sale of stock at a price above market, and the profit of the option holder will be the difference between the price stated in the put option and the market price, minus the cost of the option, commissions, and taxes. The entity that issues the stock has nothing to do with put and call) options.

**QUESTION:** 84

If a call option is out-of-the-money, the

- A. Option has expired
- B. Value of the underlying asset is less than the exercise price.
- C. Option no longer exists.
- D. Option has become a put option.

**Answer:** B.

When the value of the asset underlying a call option is less than the exercise price of the option, the option is out-of-the-money.

**QUESTION:** 85

A call option on an ordinary share is more valuable when there is a lower

- A Market value of the underlying share.
- B. Exercise price on the option.
- C. Time to maturity on the option.
- D Variability of market price on the underlying share.

**Answer:** B.

The lower the exercise price, the more valuable the call option The exercise price is the price at which the call holder has the right to purchase the underlying share.

**QUESTION: 86**

The type of option that does not have the backing of stock is called a(n)

- A. Covered option
- B. Unsecured option.
- C. Naked option
- D. Put option.

**Answer: C**

A naked or uncovered option is a call option that does not have the backing of stock. Thus, the option writer will have to purchase the underlying stock if the call option is exercised.

**QUESTION: 87**

A contractual arrangement that gives the owner the right to buy or sell an asset at a fixed price at any moment in time before or on a specified date is a(n)

- A. European option.
- B. Foreign option.
- C. Future option.
- D. American option.

**Answer: D**

An American option is a contractual arrangement that gives the owner the right to buy or sell an asset at a fixed price at any moment in time before or on a specified date.

**QUESTION: 88**

The use of derivatives to either hedge or speculate results in

- A. Increased risk regardless of motive.
- B. Decreased risk regardless of motive.
- C. Offset risk when hedging and increased risk when speculating.
- D. Offset risk when speculating and increased risk when hedging.

**Answer: C**

Derivatives, including options and futures, are contracts between the parties who

contract. Unlike stocks and bonds, they are not claims on business assets. A futures contract is entered into as either a speculation or a hedge. Speculation involves the assumption of risk in the hope of gaining from price movements. Hedging is the process of using offsetting commitments to minimize or avoid the impact of adverse price movements.

**QUESTION: 89**

An automobile company that uses the futures market to set the price of steel to protect a profit against price increases is an example of

- A. A short hedge
- B. A long hedge
- C. Selling future.-is to protect the company from loss.
- D. Selling future.-is to protect against price declines.

**Answer: B.**

A change in prices can be minimized or avoided by hedging. Hedging is the process of using offsetting commitments to minimize or avoid the impact of adverse price movements. The automobile company desires to stabilize the price of steel so that its cost to the company will not rise and cut into profits. Accordingly, the automobile company uses the futures market to create a long hedge, which is a futures contract that is purchased to protect against price increases.

**QUESTION: 90**

If a corporation holds a forward contract for the delivery of government bonds in 6 months and, during those 6 months, interest rates decline, at the end of the 6 months the value of the forward contract will have

- A. Decreased.
- B. Increased.
- C. Remained constant.
- D Any of the answers may be correct, depending on the extent of the decline in interest rates.

**Answer: B.**

Interest rate futures contracts involve risk-free bonds. When interest rates decrease over the period of a forward contract, the value of the bonds and the forward contract increase.

**QUESTION: 91**

A corporation was a party to the following transactions during November and December of the current year. Which of these transactions is most likely to be defined as a derivative?

- A. Purchased 1,000 shares of ordinary stock of a public corporation based on the assumption that the stock will increase in value.
- B. Purchased a term life insurance policy on the entity's chief executive officer to protect the entity from the effects of an untimely demise of this officer.
- C. Agreed to cosign the note of its 100%-owned subsidiary to protect the lender from the possibility that the subsidiary might default on the loan.
- D. Based on its forecasted need to purchase 300,000 bushels of wheat in 3 months, entered into a 3-month forward contract to purchase 300,000 bushels of wheat to protect itself from changes in wheat prices during the period.

**Answer: D**

A derivative is a financial instrument commonly used in hedging activities. Its value changes with the change in the underlying a specified interest rate, security price, foreign currency exchange rate, price index, commodity price, etc.). It requires little or no initial net investment compared with contracts having similar responses to changing market conditions, and it is settled in the future. The purchase of the forward contract as a hedge of a forecasted need to purchase wheat meets the criteria above. The forward contracts value will change with changes in the underlying the commodity price), requires little or no initial net investment the purchase is in three months), and settlement is in the future.

**QUESTION: 92**

The activity of trading futures with the objective of reducing or controlling risk is called

- A. Insuring.
- B. Hedging.
- C. Short-selling.
- D. Factoring.

**Answer: B.**

Hedging is the use of offsetting commitments to minimize the effect of adverse future price movements. Thus, a financial manager may limit many risk exposures by trading in futures markets.

**QUESTION: 93**

The term "short-selling" is the

- A. Selling of a security that was purchased by borrowing money from a broker.
- B. Selling of a security that is not owned by the seller.
- C. Selling of all the shares you own in an entity in anticipation that the price will decline dramatically.
- D. Betting that a stock will increase by a certain amount within a given period of time.

**Answer:** B.

Short-selling is accomplished by borrowing securities from a broker and selling those securities. At a later time, the loan is repaid by buying securities on the open market and returning them to the broker. The seller speculates that the stock's market price will decline.

**QUESTION:** 94

When an entity finances each asset with a financial instrument of the same approximate maturity as the life of the asset, it is applying

- A. Working capital management.
- B. Return maximization.
- C. Financial leverage.
- D. A hedging approach.

**Answer:** D

Maturity matching, or equalizing the life of an asset and the debt instrument used to finance that asset, is a hedging approach. The basic concept is that the entity has the entire life of the asset to recover the amount invested before having to pay the lender.

**QUESTION:** 95

A forward contract involves

- A. A commitment today to purchase a product on a specific future date at a price to be determined some time in the future.
- B. A commitment today to purchase a product some time during the current day at its present price.
- C. A commitment today to purchase a product on a specific future date at a price determined today.
- D. A commitment today to purchase a product only when its price increases above its current exercise price.

**Answer: C**

A forward contract is an executory contract in which the parties involved agree to the terms of a purchase and a sale, but performance is deferred. Accordingly, a forward contract involves a commitment today to purchase a product on a specific future date at a price determined today.

**QUESTION: 96**

The basic formula for the Black-Scholes Option Pricing Model essentially refers to the difference between the expected present value of the final stock price and the present value of the exercise price.

$$C = SN(d_1) - Ee^{-rt}N(d_2)$$

An entity wishes to price a call option written on a nondividend-paying stock using the Black-Scholes Option Pricing Model. The current stock price is US \$50. the exercise price is US \$48. the risk-free interest rate is 5.0%. the option expires in 1 year, and the cumulative probabilities used to calculate the present values of the final stock price and the exercise price are .65 and .58. respectively. If the value of  $e^{-rt}$  is .9512. the current value of the call option is

- A. US \$6.02
  - B. US \$4.66
  - C. US \$4.02
  - D. US \$2.00
- Answer

**Answer: A**

C is the current value of a call option with time t in years until expiration, S is the current stock price.  $N(d_1)$  is the cumulative probability that a deviation less than  $d_1$  will occur in a standardized normal distribution [ $N(d_1)$  is an area to the left of  $d_1$  under the curve for the standard normal distribution], E is the call's exercise price. e is a constant approximately 2.7183, and r is the annualized continuous risk-free rate of return. Thus, the value of the call is

$$\begin{aligned} C &= (\text{US } \$50 \times .65) - (\$48 \times .9512 \times .58) \\ &= \text{US } \$32.50 - (\$48 \times .9512 \times .58) \\ &= \text{US } \$32.50 - \$26.48 \\ &= \text{US } \$6.02 \end{aligned}$$

**QUESTION: 97**

An entity has a high fixed-assets turnover ratio. What conclusion can a financial analyst



draw from this?

- A. The entity may be overcapitalized.
- B. The entity may have a problem with employees converting inventory to personal use.
- C. The entity may be undercapitalized.
- D. The entity has favorable profitability.

**Answer: C**

The fixed-assets turnover ratio equals net sales divided by net fixed assets. A high ratio indicates either that the entity is undercapitalized, that is, it cannot afford to buy enough fixed assets. or that it uses fixed assets efficiently.

**QUESTION: 98**

The times-interest-earned ratio is primarily an indication of

- A. Solvency.
- B. Liquidity.
- C. Asset management.
- D. Profitability.

**Answer: A**

The times-interest-earned ratio equals profit or loss before taxes and interest divided by interest. It measures the extent to which operating profit can decline before the entity is unable to meet its annual interest cost. Thus is a measure of debt-paying capacity (solvency).

**QUESTION: 99**

An entity's receivables collection period is equal to the

- A. Inventory conversion period.
- B. Cash conversion cycle.
- C. Day's sales outstanding.
- D. Inventory divided by average daily sales.

**Answer: C**

The day's sales outstanding (days of receivables) may be stated as the accounts receivable balance divided by average credit sales per day or as days in the year divided by the receivables turnover. It is the average time required to convert the entity's receivables into

cash. Thus, it is also called the receivables collection period.

**QUESTION: 100**

The following account balances represent the December 31 balance sheet of an entity

Accounts payable	US \$ 67,000
Accounts receivable (net)	115,000
Accumulated depreciation -- building	298,500
Accumulated depreciation -- equipment	50,500
Cash	27,500
Ordinary shares (US \$10 par value)	100,000
Deferred income taxes payable (expected to reverse more than one year from now)	37,500
Equipment	136,000
Income taxes payable	70,000
Inventory	257,000
Land and building	752,000
Long-term notes payable	123,000
Financial assets held for trading	64,000
Notes payable within 1 year	54,000
Other current liabilities	22,500
Share premium	150,000
Prepaid expenses	27,000
Retained earnings	403,500

The quick ratio for this year is

- A. 1.42
- B. 1.08
- C. 0.97
- D. 0.82

**Answer: C**

The acid test (quick) ratio equals quick assets (cash, financial assets held for trading, and accounts receivable) divided by current liabilities. Quick assets total US \$206,500 (\$27,500 cash + \$64,000 financial assets held for trading + \$115,000 net accounts receivable). Given current liabilities of US \$213,500 (\$67,000 accounts payable + \$54,000 current notes payable + \$70,000 income taxes payable + \$22,500 other current liabilities), the quick ratio is 0.967 (US \$206,500 ÷ \$213,500).

**QUESTION: 101**

The following are the January 1 and June 30 balance sheets of an entity/

<u>Assets (in millions)</u>	<u>Jan. 1</u>	<u>June 30</u>
Cash	US \$ 3	US \$ 4
Accounts receivable	5	4
Inventories	8	10
Fixed assets	\$10	\$11
Total assets	<u>US \$26</u>	<u>US \$29</u>
Accounts payable	US \$ 2	US \$ 3
Notes payable	4	3
Accrued wages	1	2
Long-term debt	9	11
Equity	10	10
Total liabilities and equity	<u>US \$26</u>	<u>US \$29</u>

From January 1 to June 30, the net working capital

- A. Decreased by US \$1 million
- B. Stayed the same
- C. Increased by US \$1 million
- D. Increased by US \$2 million

**Answer: C**

Net working capital equals current assets (cash, accounts receivable, inventories for this entity) minus current liabilities (accounts payable, notes payable, accrued wages). From January 1 to June 30, the net working capital increased by US \$1.000.000  $\{[(\$4 + \$4 + \$10) - \$3 + \$3 + \$2] - [(\$3 + \$5 + \$8) - \$2 + \$4 + \$1]\}$ .

**QUESTION: 102**

A growing entity is assessing current working capital requirements. An average of 58 days is required to convert raw materials into finished goods and to sell them. Then an average of 32 days is required to collect on receivables. If the average time the entity takes to pay for its raw materials is 15 days after they are received, the total cash conversion cycle is

- A. 11 days.
- B. 41 days.
- C. 75 days.
- D. 90 days.

**Answer: C**

The cash conversion cycle is the length of time between paying for purchases and receiving cash from the sale of finished goods. It equals the inventory conversion period, plus the receivables collection period, minus the payables deferral period, or 75 days (58 days + 32 days - 15 days). An entity has a current ratio of 1.4, a quick, or acid test, ratio of 1.2, and the following partial summary balance sheet:

Cash	US \$ 10	Current liabilities	
Accounts receivable	_____	Long-term liabilities	US \$40
Inventory	_____	Equity	30
Fixed assets	_____	Total liabilities and equity	_____
Total assets	100		

**QUESTION: 103**

The entity has an accounts receivable balance of

- A. US \$12
- B. US \$26
- C. US \$36
- D. US \$66

**Answer: B.**

Total assets equal total liabilities and equity. Hence, if total assets equal US \$100, total liabilities and equity must equal US \$100, and current liabilities must equal US \$30 (\$100 - \$40 - \$30). Because the quick ratio equals the quick assets (cash + accounts receivable) divided by current liabilities, the quick assets must equal US \$36 (\$30 x 1.2 quick ratio), and the accounts receivable balance is US \$26 (\$36 - \$10 cash). An entity has a current ratio of 1.4, a quick, or acid test, ratio of 1.2, and the following partial summary balance sheet:

Cash	US \$ 10	Current liabilities	
Accounts receivable	_____	Long-term liabilities	US \$40
Inventory	_____	Equity	30
Fixed assets	_____	Total liabilities and equity	_____
Total assets	100		

**QUESTION: 104**

The entity has a fixed assets balance of

- A. US \$0
- B. US \$16
- C. US \$58
- D. US \$64

**Answer: C**

Total assets given as US \$100 equals the sum of cash given as US \$10, accounts receivable US \$26, inventory, and fixed assets. Inventory can be determined because it is included in current, but not quick, assets, and the current and quick ratios are known. Current assets equal US \$42 (1.4 current ratio x \$30 current liabilities), and the quick assets equal US \$36 (1.2 quick ratio = \$30 current liabilities). Thus, inventory, which is

the only difference in this question between current and quick assets, equals US \$6 \$42 - \$36). Fixed assets must then equal US \$58 \$100 total assets - \$10 cash - \$26 accounts receivable - \$6 inventory).

	A	B
Cash	US \$100	US \$200
Accounts receivable	unknown	100
Inventories	unknown	100
Net fixed assets	200	100
Accounts payable	100	50
Long-term debt	200	50
Ordinary shares	100	200
Retained earnings	150	100
Sales	US \$600	US \$5,800
Cost of goods sold	300	5,000
Administrative expenses	100	500
Depreciation expense	100	100
Interest expense	20	10
Income tax expense	40	95
Profit	40	95

**QUESTION: 105**

Based on 365 days per year. B. has days' sales outstanding to the nearest full day of

- A. 0 days
- B. 3 days
- C. 6 days
- D. 7 days

**Answer: C**

Days' sales of receivables (days' sales outstanding) equals the days in the year divided by the receivables turnover ratio (net credit sales - average accounts receivable). Assuming sales are net credit sales and that ending accounts receivable equals average accounts receivable, the turnover ratio is 58 (US \$5,800 - \$100), and the days' sales of receivables equals 6 days (365 - 58) rounded).

**QUESTION: 106**

A service entity's working capital at the beginning of January was 70,000. The following transactions occurred during January.

Performed services on account	US \$30,000
Purchased supplies on account	5,000
Consumed supplies	4,000
Purchased office equipment for cash	2,000
Paid short-term bank loan	6,500
Paid salaries	10,000
Accrued salaries	3,500

What is the amount of working capital at the end of January?

- A. US \$80,500

- B. US \$78,500
- C. US \$50,500
- D. US \$47,500

**Answer:** A

Working capital is the excess of total current assets (CA) over total current liabilities (CL). Thus, working capital at the end of January equals US \$80,500 computed as follows.

		CA*	CL*
Beginning working capital	US \$70,000		
Performed services on account	30,000	I	N
Purchased supplies on account	-0-	I	I
Consumed supplies	(4,000)	D	N
Purchased office equipment	(2,000)	D	N
Paid short-term bank loan	-0-	D	N
Paid salaries	(10,000)	D	N
Accrued salaries	(3,500)	N	I
Working capital, end of January	<u>US \$80,500</u>		

\* N = no effect; I = increase; D = decrease

An entity reports the following account balances at year-end.

Account	Balance
Long-term debt	US \$200,000
Cash	50,000
Net sales	600,000
Fixed assets (net)	320,000
Tax expense	67,500
Inventory	25,000
Ordinary shares	100,000
Interest expense	20,000
Administrative expense	35,000
Retained earnings	150,000
Accounts payable	65,000
Accounts receivable	120,000
Cost of goods sold	400,000
Depreciation expense	10,000
Additional Information:	

The opening balance of ordinary shares was US \$100,000. The opening balance of ordinary earnings was US \$82,500. The entity had 10,000 ordinary shares outstanding all year. No dividends were paid during the year.

**QUESTION:** 107

For the year just ended the entity has times-interest-earned of

- A. 3.375 times.
- B. 6.75 times.
- C. 7.75 times.
- D. 9.5 times.

**Answer: C**

The TIE ratio is a leverage ratio\_ It emphasizes the ability to pay interest expense. The ratio equals profit before interest and taxes divided by interest

$$= \frac{(\text{Sales} - \text{CGS} - \text{Administrative Expense} - \text{Depreciation})}{\text{Interest Expense}}$$

$$= \frac{\text{US } \$600,000 - \$400,000 - \$35,000 - \$10,000}{\text{US } \$20,000}$$

$$= 7.75 \text{ times}$$

## RST Corporation's Income Statement for Year 5 and Year 6

	Year 6	Year 5
Sales (all are credit)	US \$285,000	US \$200,000
Cost of goods sold	150,000	120,000
Gross profit	135,000	80,000
S and A expense	65,000	36,000
Profit bef. int. & inc. tax	70,000	44,000
Interest expense	3,000	3,000
Profit before income tax	67,000	41,000
Income tax expense	27,000	16,000
Profit	US \$ 40,000	US \$ 25,000

## RST Corporation's Balance Sheets End of Year 5 and Year 6

Assets	Year 6	Year 5
Current assets		
Cash	US \$ 5,000	US \$ 4,000
Financial assets held for trading	3,000	2,000
Accounts receivable (net)	16,000	14,000
Inventory	30,000	20,000
Total current assets	54,000	40,000
Noncurrent assets:		
Long-term investments	11,000	11,000
PP&E	80,000	70,000
Intangibles	3,000	4,000
Total assets	US \$148,000	US \$125,000
Liabilities and Equity		
Current liabilities:		
Accounts payable	US \$ 11,000	US \$ 7,000
Accrued payables	1,000	1,000
Total current liabilities	12,000	8,000
Bonds payable, 10%, due Year 12	30,000	30,000
Total liabilities	\$ 42,000	\$ 38,000
Equity:		
Ordinary shares,		
2,400 shares, US \$10 par	\$ 24,000	\$ 24,000
Retained earnings	82,000	63,000
Total equity	106,000	87,000
Total liabilities and equity	US \$148,000	US \$125,000

The market value of RST's ordinary stock at the end of Year 6 was US \$100.00 per share.

**QUESTION: 108**

What is RST's accounts receivable turnover for Year 6?

- A. 19 times.
- B. 16 times.
- C. 10 times.
- D. 6 times.

**Answer: A**

The accounts receivable turnover equals net credit sales divided by average trade receivables net). In Year 6, the accounts receivable turned over 19 times  $\{285,000 - [(16,000 \text{ ending AIR} + 14,000 \text{ beginning AIR}) \div 2]\}$ .

**RST Corporation's Income Statement for Year 5 and Year 6**

	<u>Year 6</u>	<u>Year 5</u>
Sales (all are credit)	US \$285,000	US \$200,000
Cost of goods sold	<u>150,000</u>	<u>120,000</u>
Gross profit	135,000	80,000
S and A expense	<u>65,000</u>	<u>36,000</u>
Profit bef. int. & inc. tax	70,000	44,000
Interest expense	<u>3,000</u>	<u>3,000</u>
Profit before income tax	67,000	41,000
Income tax expense	<u>27,000</u>	<u>16,000</u>
Profit	<u>US \$ 40,000</u>	<u>US \$ 25,000</u>

**RST Corporation's Balance Sheets End of Year 5 and Year 6**

<u>Assets</u>	<u>Year 6</u>	<u>Year 5</u>
Current assets		
Cash	US \$ 5,000	US \$ 4,000
Financial assets held for trading	3,000	2,000
Accounts receivable (net)	16,000	14,000
Inventory	<u>30,000</u>	<u>20,000</u>
Total current assets	54,000	40,000



Noncurrent assets:		
Long-term investments	11,000	11,000
PP&E	80,000	70,000
Intangibles	3,000	4,000
Total assets	<u>US \$148,000</u>	<u>US \$125,000</u>
<u>Liabilities and Equity</u>		
Current liabilities:		
Accounts payable	US \$ 11,000	US \$ 7,000
Accrued payables	<u>1,000</u>	<u>1,000</u>
Total current liabilities	12,000	8,000
Bonds payable, 10%, due Year 12	<u>30,000</u>	<u>30,000</u>
Total liabilities	<u>\$ 42,000</u>	<u>\$ 38,000</u>
Equity:		
Ordinary shares,		
2,400 shares, US \$10 par	\$ 24,000	\$ 24,000
Retained earnings	<u>82,000</u>	<u>63,000</u>
Total equity	<u>106,000</u>	<u>87,000</u>
Total liabilities and equity	<u>US \$148,000</u>	<u>US \$125,000</u>

The market value of RST's ordinary stock at the end of Year 6 was US \$100.00 per share.

**QUESTION:** 109

What is RST's current ratio at the end of Year 6?

- A. 4.5 to 1
- B. 2.4 to 1
- C. 2.0 to 1
- D. 1.5 to 1

**Answer:** A

The current ratio equals current assets divided by current liabilities. At the end of Year 6, it was 4.5 (54,000 - 12,000). RST Corporation's Income Statement for Year 5 and Year 6

	Year 6	Year 5
Sales (all are credit)	US \$285,000	US \$200,000
Cost of goods sold	<u>150,000</u>	<u>120,000</u>
Gross profit	135,000	80,000
S and A expense	<u>65,000</u>	<u>36,000</u>
Profit bef. int. & inc. tax	70,000	44,000
Interest expense	<u>3,000</u>	<u>3,000</u>
Profit before income tax	67,000	41,000
Income tax expense	<u>27,000</u>	<u>16,000</u>
Profit	<u>US \$ 40,000</u>	<u>US \$ 25,000</u>

RST Corporation's Balance Sheets End of Year 5 and Year 6

Assets	Year 6	Year 5
Current assets		
Cash	US \$ 5,000	US \$ 4,000
Financial assets held for trading	3,000	2,000
Accounts receivable (net)	16,000	14,000
Inventory	<u>30,000</u>	<u>20,000</u>
Total current assets	54,000	40,000
Noncurrent assets:		
Long-term investments	11,000	11,000
PP&E	80,000	70,000
Intangibles	<u>3,000</u>	<u>4,000</u>
Total assets	<u>US \$148,000</u>	<u>US \$125,000</u>
Liabilities and Equity		
Current liabilities:		
Accounts payable	US \$ 11,000	US \$ 7,000
Accrued payables	<u>1,000</u>	<u>1,000</u>
Total current liabilities	12,000	8,000
Bonds payable, 10%, due Year 12	<u>30,000</u>	<u>30,000</u>
Total liabilities	<u>\$ 42,000</u>	<u>\$ 38,000</u>
Equity:		
Ordinary shares,		
2,400 shares, US \$10 par	\$ 24,000	\$ 24,000
Retained earnings	<u>82,000</u>	<u>63,000</u>
Total equity	<u>106,000</u>	<u>87,000</u>
Total liabilities and equity	<u>US \$148,000</u>	<u>US \$125,000</u>

**QUESTION: 110**

What is RST's acid-test or quick) ratio at the end of Year 6?

- A. 2.40 to 1
- B. 2.18 to 1
- C. 2.00 to 1
- D. 1.50 to 1

**Answer: C**

Liquidity ratios measure the ability to meet short-term obligations. A commonly used liquidity ratio is the acid-test or quick ratio, which equals the sum of the quick assets net accounts receivable, financial assets held for trading, and cash) divided by current liabilities. This ratio at the end of Year 1. is 2.0 [(US \$5,000 + \$3,000 + \$16,000) -

\$12,000].

RST Corporation's Income Statement for Year 5 and Year 6

	Year 6	Year 5
Sales (all are credit)	US \$285,000	US \$200,000
Cost of goods sold	<u>150,000</u>	<u>120,000</u>
Gross profit	135,000	80,000
S and A expense	<u>65,000</u>	<u>36,000</u>
Profit bef. int. & inc. tax	70,000	44,000
Interest expense	<u>3,000</u>	<u>3,000</u>
Profit before income tax	67,000	41,000
Income tax expense	<u>27,000</u>	<u>16,000</u>
Profit	<u>US \$ 40,000</u>	<u>US \$ 25,000</u>

RST Corporation's Balance Sheets End of Year 5 and Year 6

Assets	Year 6	Year 5
Current assets		
Cash	US \$ 5,000	US \$ 4,000
Financial assets held for trading	3,000	2,000
Accounts receivable (net)	16,000	14,000
Inventory	<u>30,000</u>	<u>20,000</u>
Total current assets	54,000	40,000

Noncurrent assets:

Long-term investments	11,000	11,000
PP&E	80,000	70,000
Intangibles	<u>3,000</u>	<u>4,000</u>
Total assets	<u>US \$148,000</u>	<u>US \$125,000</u>

Liabilities and Equity

Current liabilities:

Accounts payable	US \$ 11,000	US \$ 7,000
Accrued payables	<u>1,000</u>	<u>1,000</u>
Total current liabilities	12,000	8,000
Bonds payable, 10%, due Year 12	<u>30,000</u>	<u>30,000</u>
Total liabilities	<u>\$ 42,000</u>	<u>\$ 38,000</u>

Equity:

Ordinary shares,		
2,400 shares, US \$10 par	\$ 24,000	\$ 24,000
Retained earnings	<u>82,000</u>	<u>63,000</u>
Total equity	<u>106,000</u>	<u>87,000</u>
Total liabilities and equity	<u>US \$148,000</u>	<u>US \$125,000</u>

**QUESTION:** 111

Based on a comparison of RST's quick ratios in Year 5 and Year 6, what is a likely conclusion?

- A. RST has improved its management of long-term investments in Year 6.
- B. RST has written off obsolete inventory in Year 6.
- C. RST's ability to meet short-term financing needs has declined since Year 5.
- D. RST's ability to meet short-term financing needs has improved since Year 5.

**Answer:** C

RST's quick ratio decreased from 2.5 in Year 5 [(US \$4,000 cash + \$2,000 financial

assets held for trading + \$14,000 net AIR] + \$8,000] to 2.0 in Year 6 [(US \$5,000 + \$3,000 + \$16,000) \$12,000]. RST has fewer assets that are easily convertible to cash available to meet current liabilities. Thus, its ability to meet short-term financing needs has declined. RST Corporation's Income Statement for Year 5 and Year 6

	Year 6	Year 5
Sales (all are credit)	US \$285,000	US \$200,000
Cost of goods sold	<u>150,000</u>	<u>120,000</u>
Gross profit	135,000	80,000
S and A expense	<u>65,000</u>	<u>36,000</u>
Profit bef. int. & inc. tax	70,000	44,000
Interest expense	<u>3,000</u>	<u>3,000</u>
Profit before income tax	67,000	41,000
Income tax expense	<u>27,000</u>	<u>16,000</u>
Profit	<u>US \$ 40,000</u>	<u>US \$ 25,000</u>

RST Corporation's Balance Sheets End of Year 5 and Year 6

Assets	Year 6	Year 5
Current assets		
Cash	US \$ 5,000	US \$ 4,000
Financial assets held for trading	3,000	2,000
Accounts receivable (net)	16,000	14,000
Inventory	<u>30,000</u>	<u>20,000</u>
Total current assets	54,000	40,000
Noncurrent assets:		
Long-term investments	11,000	11,000
PP&E	80,000	70,000
Intangibles	<u>3,000</u>	<u>4,000</u>
Total assets	<u>US \$148,000</u>	<u>US \$125,000</u>
Liabilities and Equity		
Current liabilities:		
Accounts payable	US \$ 11,000	US \$ 7,000
Accrued payables	<u>1,000</u>	<u>1,000</u>
Total current liabilities	12,000	8,000
Bonds payable, 10%, due Year 12	<u>30,000</u>	<u>30,000</u>
Total liabilities	<u>\$ 42,000</u>	<u>\$ 38,000</u>
Equity:		
Ordinary shares,		
2,400 shares, US \$10 par	\$ 24,000	\$ 24,000
Retained earnings	<u>82,000</u>	<u>63,000</u>
Total equity	<u>106,000</u>	<u>87,000</u>
Total liabilities and equity	<u>US \$148,000</u>	<u>US \$125,000</u>

**QUESTION: 112**

Based on the balance sheet shown in Exhibit A, the debt ratio is

- A. 20%
- B. 40%
- C. 50%
- D. 100%

**Answer: C**

The debt ratio equals total debt divided by total assets, or .50 [(US \$3,000,000,000 total debt and equity - \$500,000,000 ordinary equity - \$1,000,000,000 retained earnings) + \$3,000,000,000 total assets].

**QUESTION: 113**

Which of the outcomes represented in the following table would result from an entity's retirement of debt with excess cash?

	Total Assets Turnover Ratio	Following Period's Interest- Earned Ratio
A.	Increase	Increase
B.	Increase	Decrease
C.	Decrease	Increase
D.	Decrease	Decrease

**Answer: A**

Because total assets will decline without any impact on sales, the total assets turnover ratio [sales ÷ total assets] will increase. In addition, a reduced debt level should cause a reduction in annual interest payments, so the times-interest-earned ratio [(profit + interest + taxes) ÷ interest] should increase.

**QUESTION: 114**

An entity purchased a new machine for US \$' 610,100 by borrowing the required funds from a bank for 180 days. What will be the direct impact of this transaction?

- A. Decrease the current ratio and increase the debt ratio.
- B. Increase the current ratio and decrease the debt ratio.
- C. Increase the current ratio and increase the debt ratio.
- D. Decrease the current ratio and decrease the debt ratio.

**Answer: A**

The borrowing of funds for 180 days constitutes short-term borrowing. The new machine is a fixed asset. Current liabilities have increased, and current assets have remained constant. Consequently, the current ratio (current assets ÷ current liabilities) has decreased. Total debt and total assets increased by the same absolute amount, and the debt ratio (total debt ÷ total assets) should have increased, assuming total debt is less than total asset.

**QUESTION: 115**

Which group of ratios would be useful in evaluating the effectiveness of working capital

management?

- A. Profit margin, acid-test ratio, and return on assets.
- B. Acid-test ratio, inventory turnover ratio, and average collection period ratio
- C. Inventory turnover ratio, times interest earned, and debt-to-equity ratio.
- D. Acid-test ratio, current ratio, and return on equity.

**Answer:** B.

Working capital equals current assets minus current liabilities. The acid-test ratio equals quick assets current assets - inventory - prepaid expenses) divided by current liabilities. Inventory a current asset) turnover equals cost of goods sold divided by divided inventory. The average collection period number of days' sales in accounts receivable, a current asset) equals the number of days in a year divided by the accounts receivable turnover net credit sales ÷ average receivables). The foregoing are some of the many ratios that can be used to evaluate working capital management.

**QUESTION:**116

An analysis of inventory turnover in a store's clothing department indicated extremely low turnover. Which of the following would most likely increase the turnover rate?

- A. Increase inventories.
- B. Increase sales incentives.
- C Increase selling prices.
- D Decrease the frequency of purchases but maintain the same level of inventory.

**Answer:** B.

Inventory turnover equals cost of sales divided by average inventory. Reducing inventory therefore increases turnover. Sales incentives to improve sales should lower inventory levels. Presented below are partial year-end financial statement data for entities A and B.

	A	B
Cash	US \$100	US \$200
Accounts receivable	unknown	100
Inventories	unknown	100
Net fixed assets	200	100
Accounts payable	100	50
Long-term debt	200	50
Ordinary shares	100	200
Retained earnings	150	100
	A	B
Sales	US \$600	US \$5,800
Cost of goods sold	300	5,000
Administrative expenses	100	500
Depreciation expense	100	100
Interest expense	20	10
Income tax expense	40	95
Profit	40	95

**QUESTION: 117**

A has a times-interest-earned ratio of

- A. Four times.
- B. Five times.
- C. 10 times.
- D. 15 times.

**Answer: B.**

The times-interest-earned ratio for A equals profit before interest and tax divided by interest expense. Profit before interest and tax is US \$100 (\$40 profit + \$20 interest + \$40 tax expense). Hence, interest was earned five times US \$100 ÷ \$20.

An entity had the following number of shares outstanding during the year:

<u>Period</u>	<u>Shares Outstanding</u>
January 1 - April 30	60,000
May 1 - June 30	96,000
July 1 - September 30	90,000
October 1 - December 31	70,000

During the year, the entity of US \$600,000. It paid US \$100,000 in preference dividends, declared and paid US \$250,000 of ordinary share dividends, and paid US \$50,000 of interest to debt holders.

**QUESTION: 118**

The number of shares the entity had outstanding for the year, for the purpose of computing basic earnings per share (BEPS), is

- A. 65,000
- B. 70,000
- C. 76,000
- D. 79,000

**Answer: C**

The weighted-average number of shares outstanding for the year (76,000 shares) is used in the BEPS calculation.

<u>Dates Outstanding</u>	<u>Shares Outstanding</u>	<u>Fraction of Year</u>	<u>Weighted Shares</u>
January 1 - April 30	60,000	4 ÷ 12	20,000
May 1 - June 30	96,000	2 ÷ 12	16,000
July 1 - September 30	90,000	3 ÷ 12	22,500
October 1 - December 31	70,000	3 ÷ 12	17,500
			<u>76,000</u>

**QUESTION: 119**

An entity has total asset turnover of 3.5 times and a total debt to total assets ratio of 70%. If the entity has total debt of US \$1,000,000, it has a sales level of

- A. US \$5,000,000.00
- B. US \$2,450,000.00
- C. US \$408,163.26
- D. US \$200,000.00

**Answer: A**

If the debt-to-total assets ratio is 70% and debt is US \$1,000,000, total assets must be US \$1,428,571.4 (\$1,000,000 ÷ 7). Given total asset turnover sales - total assets) of 3.5, sales must be US \$5,000,000 (3.5 x \$1,428,571.4).

**QUESTION: 120**

An entity has US \$400 of current assets, composed of US \$200 of cash, US \$100 of accounts receivable, and US \$100 of inventory. The entity has US \$200 of long-term debt, US \$100 of accounts payable, and US \$75 of notes payable. The notes payable are due in 6 months. The acid-test ratio, to two decimal places, is

- A. 0.80
- B. 1.29
- C. 1.71
- D. 2.29

**Answer: C**

The acid-test ratio equals current assets (US \$400 minus inventories US \$100), divided by current liabilities (US \$100 + \$75 = US \$175), or 1.71.

**QUESTION: 121**

Given an acid-test ratio of 2.0, current assets of US \$5,000, and inventory of US \$2,000, the value of current liabilities is

- A. US \$1,500
- B. US \$2,500
- C. US \$3,500
- D. US \$6,000



**Answer: A**

The acid-test or quick ratio equals the ratio of the quick assets (cash, net accounts receivable, and marketable securities) divided by current liabilities. Current assets equal the quick assets plus inventory and prepaid expenses. This question assumes that the entity has no prepaid expenses. Given current assets of US \$5,000, inventory of US \$2,000 and no prepaid expenses, the quick assets must be US \$3,000. Because the acid-test ratio is 2.0, the quick assets are double the current liabilities. Current liabilities therefore are equal to \$1,500 (\$3,000 quick assets ÷ 2.0).

**QUESTION: 122**

The following transactions occurred during a company's first year of operations:

- I Purchased a delivery van for cash
- II. Borrowed money by issuance of short-term debt
- III Purchased treasury stock

Which of the items above caused a change in the amount of working capital?

- A. I only
- B. I and II only
- C. II and III only
- D. I and III only.

**Answer: D**

Working capital is computed by deducting total current liabilities from total current assets. The purchase of a delivery van for cash reduces current assets and has no effect on current liabilities. The borrowing of cash by incurring short-term debt increases current assets by the same amount as it increases current liabilities, hence, it will have no effect on working capital. The purchase of treasury stock decreases current assets but has no effect on current liabilities. Thus, the purchases of the van and treasury stock affect working capital.

**QUESTION: 123**

A condensed comparative balance sheet for an entity appears below:

	<u>12/31/Yr 1</u>	<u>12/31/Yr 2</u>
Cash	US \$ 40,000	US \$ 30,000
Accounts receivable	120,000	100,000
Inventory	200,000	300,000
Property, plant, & equipment	500,000	550,000
Accumulated depreciation	(280,000)	(340,000)
Total assets	<u>US \$ 580,000</u>	<u>US \$ 640,000</u>
Current liabilities	US \$ 60,000	US \$ 100,000
Long-term liabilities	390,000	420,000
Stockholders' equity	130,000	120,000
Total liabilities and equity	<u>US \$ 580,000</u>	<u>US \$ 640,000</u>

In looking at liquidity ratios at both balance sheet dates, what happened to the 1) current ratio and 2) acid-test (quick) ratio?

	<u>(1) Current Ratio</u>	<u>(2) Acid-Test Ratio</u>
A.	Increased	Increased
B.	Increased	Decreased
C.	Decreased	Increased
D.	Decreased	Decreased

**Answer: D**

The current ratio is determined by dividing current assets by current liabilities. The acid-test ratio is determined by dividing quick assets by current liabilities. At December 31, Year 1. The current ratio is 6 to 1 [(US \$40,000 + \$120,000 + \$200,000) - \$60,000]. At December 31, Year 2, the current ratio is 4.3 to 1 [(US \$30,000 + \$100,000 + \$300,000) - \$100,000]. Hence, there was a decrease in the current ratio. At December 31, Year 1, the acid-test ratio is 2.667 to 1 [(US \$40,000 + \$120,000) - \$60,000]. At December 31, Year 2, the acid-test ratio is 1.3 to 1 [(US \$30,000 + \$100,000) - \$100,000]. Thus, the acid-test ratio also declined. An entity's financial statements for the current year are presented below:

<u>Balance Sheet</u>		<u>Statement of Income and Retained Earnings</u>	
Cash	US \$100	Sales	US \$3,000
Accounts receivable	200	Cost of goods sold	<u>1,600</u>
Inventory	50	Gross profit	1,400
Net fixed assets	<u>600</u>	Operations expenses	<u>970</u>
Total	<u>US \$950</u>	Operating profit	430
Accounts payable	US \$140	Interest expense	<u>30</u>
Long-term debt	300	Profit before tax	400
Share capital	260	Income tax	<u>200</u>
Retained earnings	<u>250</u>	Profit	200
Total	<u>US \$950</u>	Plus Jan. 1 retained earnings	150
		Minus dividends	<u>100</u>
		Dec. 31 retained earnings	<u>US \$ 250</u>

**QUESTION: 124**

The networking capital is

- A. US \$160
- B. US \$210
- C. US \$350
- D. US \$490

**Answer: B.**

Net working capital is the difference between current assets and current liabilities. It equals US \$210 (\$100 cash + \$200 A/R + \$50 inventory - \$140 A/P).

**QUESTION: 125**

Which of the following is true about the impact of price inflation on financial ratio analysis?

- A. Inflation impacts only those ratios computed from balance sheet accounts.
- B. Inflation impacts financial ratio analysis for one entity over time, but not comparative analysis of entities of different ages.
- C. Inflation impacts financial ratio analysis for one entity overtime, as well as comparative analysis of entities of different ages.
- D. Inflation impacts comparative analysis of entities of different ages, but not financial ratio analysis for one entity over time.

**Answer: C**

Inflation has considerable impact on financial ratio analysis. This impact distorts both analysis of a single entity overtime and comparative analysis of different aged entities. During the year ended December 31, an entity had US \$500,000 in sales revenue and purchased US \$150,000 of inventory. The cost of goods sold was US \$250,000 for the year, and the entity incurred US \$ 25,000 of general and administrative expenses. The January 1 opening balance sheet was as follows:

Cash		US \$120,000
Accounts receivable		100,000
Inventory		200,000
Fixed assets (gross)	US \$600,000	
Accum. depreciation	<u>(100,000)</u>	
Net fixed assets		<u>500,000</u>
Total assets		<u><u>US \$920,000</u></u>
Accounts payable		220,000
Long-term debt		400,000
Ordinary shares		100,000
Retained earnings		<u>200,000</u>
Total liabilities and equity		<u><u>US \$920,000</u></u>

The cost of long-term debt financing is 10% per annum, payable in one installment on December 31 of each year. The entity has a 50% tax rate. The entity has a dividend

payout ratio of 25%. The fixed assets were 1-year old at the start of the current year. were originally estimated to have a 6-year useful life. and are being depreciated on the straight-line basis.

**QUESTION: 126**

The entity will pay dividends for the year of

- A. US \$10,625
- B. US \$21,250
- C. US \$23,125
- D. US \$42,500

**Answer: A**

The entity has a dividend payout ratio of 25% of profit. Profit before taxes is US \$85,000 [\$500,000 sales - \$250,000 CGS - \$25,000 G&A expenses - \$400,000 LT debt x 10% interest rate) - \$600,000 fixed assets - 6 years)]. Hence, after-tax profit is US \$42,500 [\$85,000 x 1.0 - .5)], and the dividend payout is US \$10,625 (\$42,500 25%). During the year ended December 31. an entity had US \$500,000 in sales revenue and purchased US \$150,000 of inventory. The cost of goods sold was US \$250,000 for the year, and the entity incurred US \$ 25.000 of general and administrative expenses. The January 1 opening balance sheet was as follows:

Cash		US \$120,000
Accounts receivable		100,000
Inventory		200,000
Fixed assets (gross)	US \$600,000	
Accum. depreciation	<u>(100,000)</u>	
Net fixed assets		<u>500,000</u>
Total assets		<u>US \$920,000</u>
Accounts payable		220,000
Long-term debt		400,000
Ordinary shares		100,000
Retained earnings		<u>200,000</u>
Total liabilities and equity		<u>US \$920,000</u>

The cost of long-term debt financing is 10% per annum, payable in one installment on December 31 of each year. The entity has a 50% tax rate. The entity has a dividend payout ratio of 25%. The fixed assets were 1-year old at the start of the current year were originally estimated to have a 6-year useful life. and are being depreciated on the straight-line basis.

**QUESTION: 127**

What would be the effect of a lower tax rate on the ending balance of ordinary shares and on dividends said for the year?

	<u>Ending Balance of Ordinary Shares</u>	<u>Dividends Paid</u>
A.	Increase	Increase
B.	Decrease	Decrease
C.	No effect	Increase
D.	No effect	Decrease

**Answer: C**

The balance in the ordinary shares account represents share capital i.e. capital contributed by owners, not earnings retained in the business. It is not affected by a change in tax rate. If dividends will increase, not however, because they are a constant percentage of after-tax earnings. An entity reports the following account balances at year-end:

<u>Account</u>	<u>Balance</u>
Long-term debt	US \$200,000
Cash	50,000
Net sales	600,000
Fixed assets (net)	320,000
Tax expense	67,500
Inventory	25,000
Ordinary shares	100,000
Interest expense	20,000
Administrative expense	35,000
Retained earnings	150,000
Accounts payable	65,000
Accounts receivable	120,000
Cost of goods sold	400,000
Depreciation expense	10,000

The opening balance of ordinary shares was US \$100,000. The opening balance of ordinary earnings was US \$82,500. The entity had 10,000 ordinary shares outstanding all year. No dividends were paid during the year.

**QUESTION: 128**

At year-end, the entity has a book value per share of

- A. US \$10.00
- B. US \$15.00
- C. US \$21.63
- D. US \$25.00

**Answer: D**

Book value per share based, on balance sheet amounts, measures the per share amount

that would be received if the entry were liquidated. The ratio is calculated as ordinary equity divided by the number of outstanding shares.

$$\begin{aligned}
 &= \frac{\text{Equity in ordinary Shares} + \text{Retained Earnings}}{\text{Outstanding Shares}} \\
 &= \frac{\text{US } \$100,000 + \$150,000}{10,000 \text{ shares}} \\
 &= \text{US } \$25
 \end{aligned}$$

<u>Account</u>	<u>Balance</u>
Long-term debt	US \$200,000
Cash	50,000
Net sales	600,000
Fixed assets (net)	320,000
Tax expense	67,500
Inventory	25,000
Ordinary shares	100,000
Interest expense	20,000
Administrative expense	35,000
Retained earnings	150,000
Accounts payable	65,000
Accounts receivable	120,000
Cost of goods sold	400,000
Depreciation expense	10,000
Additional Information:	

The opening balance of ordinary shares was US \$100,000. The opening balance of ordinary earning was US \$82,500. The entity had 10,000 ordinary shares outstanding all year. No dividends were paid during the year.

**QUESTION: 129**

For the year just ended, the entity had a rate of return on equity, rounded to two decimals, of

- A. 31.21%
- B. 58.06%
- C. 67.50%
- D. 71.68%

**Answer: A**

Rate of return on equity, a profitability ratio, measures the rate of return on investment. The ratio equals profit minus any preference dividends) divided by average ordinary equity.

$$\begin{aligned}
 &= \frac{\text{Sales} - \text{CGS} - \text{Adm. Exp.} - \text{Deprec.} - \text{Interest} - \text{Tax}}{(\text{Beginning Ordinary Equity} + \text{Ending Ordinary Equity}) \div 2} \\
 &= \frac{\text{US } \$600,000 - \$400,000 - \$35,000 - \$10,000 - \$20,000 - \$67,500}{(\text{US } \$182,500 + \$250,000) \div 2} \\
 &= \frac{\text{US } \$67,500}{\text{US } \$216,250} \\
 &= 31.21\%
 \end{aligned}$$

**QUESTION: 130**

Which of the following is true about the impact of price inflation on financial ratio analysis?

- A. Inflation has no impact on financial ratio analysis.
- B. Inflation affects financial ratio analysis for one entity over time but not comparative analysis of entities of different ages.
- C. Inflation affects financial ratio analysis for one entity over time, as well as comparative analysis of entities of different ages.
- D. Inflation affects comparative analysis of entities of different ages but not financial ratio analysis for one entity over time.

**Answer: C**

Inflation is the diminution over time of the purchasing power of money. Because balance sheet amounts are expressed in terms of money, historical cost amounts for different periods are measured in units representing different levels of purchasing power. Profit or loss is also distorted because of inflation's impact on depreciation expense and inventory costs. Inflation therefore impairs the comparability of financial statement items, whether for the same entity overtime or for entities of differing ages. Presented below are partial year-end financial statement data for entities A and B.

	A	B
Cash	US \$100	US \$200
Accounts receivable	unknown	100
Inventories	unknown	100
Net fixed assets	200	100
Accounts payable	100	50
Long-term debt	200	50
Ordinary shares	100	200
Retained earnings	150	100
	A	B
Sales	US \$600	US \$5,800
Cost of goods sold	300	5,000
Administrative expenses	100	500
Depreciation expense	100	100
Interest expense	20	10
Income tax expense	40	95
Profit	40	95

**QUESTION: 131**

If A has 60 ordinary shares outstanding, it has a book value per share of approximately.

- A. US \$1.67
- B. US \$2.50
- C. US \$4.17
- D. US \$5.00

**Answer: C**

The book value per share for A equals the sum of ordinary shares and retained earnings, divided by the number of shares, or US \$4.17  $[(\$100 - \$150) - 60]$ .

**QUESTION: 132**

The purchase of treasury shares with an entity's surplus cash

- A. Increases an entity's financial leverage.
- B. Increases an entity's equity.
- C. Increases an entity's interest coverage ratio.
- D. Dilutes an entity's earnings per share.

**Answer: A**

A purchase of treasury share involves a decrease in assets (usually cash) and a corresponding decrease in shareholders' equity. Thus, equity is reduced and the debt-to-equity ratio and financial leverage increase.

**QUESTION: 133**

In calculating diluted earnings per share when an entity has convertible bonds outstanding, the weighted-average number of ordinary shares outstanding must be <List A> to adjust for the conversion feature of the bonds, and the profit attributable to ordinary shareholders must be <List B> by the amount of interest expense on the bonds, net of tax.

List A List B

- A. Increased Increased
- B. Increased Decreased
- C. Decreased Increased
- D. Decreased Decreased

**Answer: A**

The weighted-average number of ordinary shares outstanding must be increased to 7



reflect the shares into which the bonds could be converted. Also, the effect of the bond interest on profit attributable to ordinary shareholders profit after subtracting preference dividends) must be eliminated. In this way, diluted earnings per share is calculated as if the bonds had been converted into ordinary shares as of the start of the year.

**QUESTION: 134**

An investor has been given several financial ratios for an entity but none of the financial reports. Which combination of ratios can be used to derive return on equity?

- A. Market-to-book-value ratio and total-debt-to-total-assets ratio.
- B. Price-to-earnings ratio, earnings per share, and profit margin.
- C. Price-to-earnings ratio and return-on-assets ratio.
- D. Profit margin, total assets turnover, and equity multiplier.

**Answer: D**

The profit margin equals the profit available to ordinary shareholders divided by sales, the total assets turnover equals sales divided by total assets, and the product of these two ratios is the return on assets. This result is the basic Du Pont equation. In the extended Du Pont equation, the return on assets is multiplied by the leverage factor, also called the equity multiplier total assets + ordinary equity at carrying amount). The extended Du Pont equation gives the return on ordinary equity. This result is obtained because the total assets and sales factors cancel in the multiplication of the three ratios.

**QUESTION: 135**

The following ratios relate to an entity's financial situation compared with that of its

	<u>The Entity</u>	<u>Industry Average</u>
Return on assets (ROA)	7.9%	9.2%
Return on equity (ROE)	15.2%	12.9%

What conclusion could a financial analyst validly draw from these ratios?

- A. The entity's product has a high market share, leading to higher profitability.
- B. The entity uses more debt than does the average entity in the industry.
- C. The entity's profits are increasing over time.
- D. The entity's shares have a higher market value to carrying amount than does the rest of the industry.

**Answer: B.**

The use of financial leverage has a multiplier effect on the return on assets. The extended

Du Pont formula illustrates this point by showing that the return on equity equals the return on assets times the equity multiplier (total assets ÷ ordinary equity). Thus, greater use of debt increases the equity multiplier and the return on equity. In this example, the equity multiplier is 1.40 (15.2% ROE ÷ 10.9% ROA), and the industry average is 1.40 (12.9% ROE ÷ 9.2% ROA). The higher equity multiplier indicates that the entity uses more debt than the industry average.

**Exhibit A**  
**Balance Sheet**

	Year 1 (millions)
<u>Assets</u>	
Cash	US \$ 300
Financial assets held for trading	400
Accounts receivable	200
Inventories	400
Net plant and equipment	1,700
Total assets	<u>US \$3,000</u>
<u>Liabilities and Equity</u>	
Accounts payable	US \$ 300
Notes payable	400
Accrued wages	50
Accrued taxes	150
Debentures	600
Ordinary shares	500
Retained earnings	1,000
Total liabilities and equity	<u>US \$3,000</u>

**QUESTION: 136**

An entity experienced sales of US \$5 billion, profit before interest and taxes of US \$200 million, profit before taxes of US \$100 million, and profit of US \$70 million. Based on this information and the entity's balance sheet information in Exhibit A, the return on equity (ROE) is

- A. 4.67%
- B. 6.67%
- C. 13.33%
- D. 14%

**Answer: A**

The return on equity equals profit (US \$70,000,000) divided by equity (\$500,000,000 ordinary shares ÷ \$1,000,000,000 retained earnings).

**QUESTION: 137**

Which of the following financial statement analyses is most useful in determining whether the various expenses of a given entity are higher or lower than industry

averages?

- A. Horizontal.
- B. Vertical.
- C. Activity ratio.
- D. Defensive-interval ratio.

**Answer:** B.

Vertical analysis is the expression of each item on a financial statement in a given period in relation to a base figure. On the income statement, each item is stated as a percentage of sales. Thus, the percentages for the entity in question can be compared with industry norms.

**QUESTION:** 138

Return on investment (ROI) is a very popular measure employed to evaluate the performance of corporate segments because it incorporates all of the major ingredients of profitability (revenue, cost, investment) into a single measure. Under which one of the following combinations of actions regarding a segment's revenues, costs, and investment would a segment's ROI always increase?

	<u>Revenues</u>	<u>Costs</u>	<u>Investment</u>
A.	Increase	Decrease	Increase
B.	Decrease	Decrease	Decrease
C.	Increase	Increase	Increase
D.	Increase	Decrease	Decrease

**Answer:** D

An increase in revenue and a decrease in costs will increase the ROI numerator. A decrease in investment will decrease the denominator. The ROI must increase in this situation.

**QUESTION:** 139

All else being equal, an entity with a higher dividend-payout ratio will have a <List A> debt-to-assets ratio and a <List B> current ratio.

	<u>List A</u>	<u>List B</u>
A.	Higher	Higher
B.	Higher	Lower
C.	Lower	Higher
D.	Lower	Lower

**Answer:** B.

An entity with a higher dividend-payout ratio is distributing more of its earnings as dividends to ordinary shareholders. It will have less cash and less total assets than a comparable entity with a lower payout ratio. The debt-to-assets ratio will be higher because total assets are lower, and the current ratio will be lower because cash is lower. An entity's financial statements for the current year are presented below:

<u>Balance Sheet</u>	
Cash	US \$100
Accounts receivable	200
Inventory	50
Net fixed assets	<u>600</u>
Total	<u>US \$950</u>
Accounts payable	140
Long-term debt	300
Share capital	260
Retained earnings	<u>250</u>
Total	<u>950</u>

<u>Statement of Income and Retained Earnings</u>	
Sales	US \$3,000
Cost of goods sold	<u>1,600</u>
Gross profit	1,400
Operations expenses	<u>970</u>
Operating profit	430
Interest expense	<u>30</u>
Profit before tax	400
Income tax	<u>200</u>
Profit	200
Plus Jan. 1 retained earnings	150
Minus dividends	<u>100</u>
Dec. 31 retained earnings	<u>US \$ 250</u>

**QUESTION:** 140

The Entity has dividend-payoyt ratio of

- A. 19.6%
- B. 28.6%
- C. 40.0%
- D. 50.0%

**Answer: D**

The dividend-payout ratio is the ratio of dividends paid to profit for the period. Hence, it equals 50.0% US \$100 dividends \$200 profit). An entity's financial statements for the current year are presented below:

<u>Balance Sheet</u>	
Cash	US \$100
Accounts receivable	200
Inventory	50
Net fixed assets	600
Total	<u>US \$950</u>
Accounts payable	140
Long-term debt	300
Share capital	260
Retained earnings	250
Total	<u>950</u>

<u>Statement of Income and Retained Earnings</u>	
Sales	US \$3,000
Cost of goods sold	<u>1,600</u>
Gross profit	1,400
Operations expenses	<u>970</u>
Operating profit	430
Interest expense	<u>30</u>
Profit before tax	400
Income tax	<u>200</u>
Profit	200
Plus Jan. 1 retained earnings	150
Minus dividends	<u>100</u>
Dec. 31 retained earnings	<u>US \$ 250</u>

**QUESTION: 141**

The entity has return on assets of

- A. 21.1%
- B. 39.2%
- C. 42.1%
- D. 45.3%

**Answer: A**

The return on assets is the ratio of profit to total assets. It equals 21.1% US \$200 profit \$950 total assets). An entity's financial statements for the current year are presented below:

<u>Balance Sheet</u>	
Cash	US \$100
Accounts receivable	200
Inventory	50
Net fixed assets	<u>600</u>
Total	<u>US \$950</u>
Accounts payable	140
Long-term debt	300
Share capital	260
Retained earnings	<u>250</u>
Total	<u>950</u>

<u>Statement of Income and Retained Earnings</u>	
Sales	US \$3,000
Cost of goods sold	<u>1,600</u>
Gross profit	1,400
Operations expenses	<u>970</u>
Operating profit	430
Interest expense	<u>30</u>
Profit before tax	400
Income tax	<u>200</u>
Profit	200
Plus Jan. 1 retained earnings	150
Minus dividends	<u>100</u>
Dec. 31 retained earnings	<u>US \$ 250</u>

**QUESTION: 142**

The entity has a profit margin of

- A 6.67%
- B. 13.33%
- C 14.33%
- D 46.67%

**Answer: A**

The profit margin is the ratio of profit to sales. It equals 6.67% (US \$200 profit / \$3,000 sales).

**QUESTION: 143**

An entity has 100,000 outstanding ordinary shares with a market value of US \$20 per share. Dividends of US \$2 per share were paid in the current year, and the entity has a dividend-payout ratio of 40%. The price-to-earnings ratio of the entity is

- A. 25
- B. 4
- C. 10
- D. 50

**Answer: B**

The P-E ratio equals the share price divided by EPS. If the dividends per share equaled US \$2 and the dividend-payout ratio was 40%, EPS must have been US \$5 (\$2 ÷ .4). Accordingly, the P-E ratio is 4 (US \$20 share price ÷ \$5 EPS). Entity A has 50,000 ordinary shares and 10,000 preference shares outstanding at the start of the year on January 1. The preference shares are entitled to a US \$2 per share annual cash dividend, payable on December 31. The entity had profit of US \$1517,000 for the year. On April 1, the entity issued 15,000 additional ordinary shares for cash. Entity B. is identical to entity A in all respects except that it had 75,000 ordinary shares outstanding for the entire year.

**QUESTION: 144**

Basic earnings per share for entity B. is approximately

- A US \$1.73
- B. US \$1.87
- C. US \$2.00
- D. US\$227

**Answer: A**

BEPS equals profit minus preference dividends, divided by ordinary shares outstanding. Thus, BEPS equals US \$1.73  $\{ [\$150,000 - \$2 \times 10,000 \text{ preference shares}] \div 75,000 \text{ ordinary shares} \}$ .

**QUESTION: 145**

Which denominator used in the return on investment (ROI) formula is criticized because it combines the effects of operating decisions made at one organizational level with financing decisions made at another organizational level?

- A. Total assets employed.
- B. Equity.
- C. Working capital plus other assets.
- D. Total assets available.

**Answer: B.**

ROI equals income divided by invested capital. The denominator may be defined in various ways, e.g., total assets available, assets employed, working capital plus other assets, and equity. If equity (total assets - total liabilities) is chosen, a portion of long-term liabilities must be allocated to the investment center to determine the manager's

resource base. One problem with this definition of the resource base is that, although it has the advantage of emphasizing return to owners, it reflects decisions at different levels of the entity: short-term liabilities incurred by the responsibility center operating decisions) and long-term liabilities controlled at the corporate level long-term financing decisions).

**QUESTION: 146**

Earnings-per-share data must be reported on the face of the income statement for

	<u>Profit or Loss from Continuing Operations</u>	<u>Discontinued Operation</u>
A.	Yes	Yes
B.	Yes	No
C.	No	No
D.	No	Yes

**Answer: B.**

EPS data for profit or loss from continuing operations and profit or loss must be reported on the face of the income statement. EPS data for a discontinued operation may be disclosed on the face of the income statement or in a note.

**QUESTION: 147**

In the computation of DEPS, which of the following are potential ordinary shares?

	<u>Nonconvertible Preference Shares</u>	<u>Share Options</u>
A.	Yes	No
B.	Yes	Yes
C.	No	Yes
D.	No	No

**Answer: C**

Potential ordinary shares are contracts that may entitle holders to obtain ordinary shares. They include options, warrants, convertible preference shares, convertible debt, and contingently issuable shares. Unlike an option, nonconvertible preference shares are never potential ordinary shares.

**QUESTION: 148**

In computing the loss per share of ordinary shares, cumulative preference dividends not earned should be



- A. Deducted from the loss for the year.
- B. Added to the loss for the year.
- C. Deducted from income in the year paid.
- D. Added to income in the year paid.

**Answer:** B.

When preference shares are cumulative, the dividend, whether earned or not, is deducted from profit or loss from continuing operations and profit or loss, or added to any loss for the year, in computing earnings or loss. When preference shares are noncumulative, an adjustment is made for dividends declared. If the dividend is cumulative only if earned, no adjustment is necessary except to the extent of available income: that is, the preference dividends accumulate only to the extent of profit or loss.

**QUESTION:** 149

An entity had 300,000 shares of ordinary shares issued and outstanding at December 31. Year 1 No shares were issued during Year 2. On January 1, Year 2, the entity issued 200,000 shares of nonconvertible preference shares. During Year 2, the entity declared and paid US \$75,000 of cash dividends on the ordinary shares and US \$60,000 on the preference shares. Profit for the year ended December 31. Year 2 was US \$330,000. What is the entity's Year 2 basic earnings per share?

- A. US \$1.10
- B. US \$0.90
- C. US \$0.85
- D. US \$0.65

**Answer:** B.

BEPS is equal to the amount of profit or loss attributable to ordinary equity holders divided by the weighted-average number of ordinary shares outstanding during the year. To calculate the numerator, dividends on cumulative preference shares must be subtracted from profit or loss whether or not the dividends were declared. Earnings per share for Year 2 thus amounted to US \$0.90.

$$\frac{\text{US } \$330,000 - \$60,000}{\text{US } \$300,000} = \text{US } \$0.90$$

**QUESTION:** 150

A corporation had profit for the year of US \$101,504 and a simple capital structure consisting of the following ordinary shares outstanding:

<u>Months Outstanding</u>	<u>Number of Shares</u>
January - February	24,000
March - June	29,400
July - November	36,000
December	<u>35,040</u>
Total	<u>124,440</u>

What was the corporation's basic earnings per share rounded to the nearest cent)?

- A. US \$2.90
- B. US \$3.20
- C. US \$3.26
- D. US \$3.45

**Answer: B.**

BEPS equals profit or loss attributable to ordinary equity holders divided by the weighted- average number of ordinary shares outstanding. The latter is calculated as follows:

$$\begin{array}{rcl}
 24,000 \times (2 \div 12) & = & 4,000 \\
 29,400 \times (4 \div 12) & = & 9,800 \\
 36,000 \times (5 \div 12) & = & 15,000 \\
 35,040 \times (1 \div 12) & = & \underline{2,920} \\
 & & \underline{31,720}
 \end{array}$$

Accordingly, BEPS is US \$3.20 (\$101,504 profit ÷ 31,720 shares).

**QUESTION: 151**

When an entity reports amounts for basic and diluted earnings per share,

- A. The entity should be presented with equal prominence on the face of the income statement.
- B. The entity need not be shown on the face of the income statement but must be disclosed in the notes to the financial statements.
- C. The entity need to be reported for profit or loss only.
- D. BEPS should be presented on the face of the income statement. DEPS may be disclosed either on the face of the income statement or in the notes.

**Answer: A**

A public entity or any entity that discloses EPS must report EPS information on the face of the income statement for both profit or loss from continuing operations and profit or loss. In addition, EPS data for any discontinued operation must be presented on the face

of the income statement or in a note. The entity must present BEPS and DEPS with equal prominence.

**QUESTION: 152**

In a diluted earnings-per-share computation, outstanding options issued by the reporting entity are assumed to be exercised. If the exercise price of these options exceeds the average market price, the computation would

- A. Fairly present diluted earnings per share on a prospective basis.
- B. Fairly present the maximum potential dilution of diluted earnings per share on a prospective basis.
- C. Reflect the excess of the number of shares assumed issued at the average market price over the number of shares assumed issued at the exercise price.
- D. Be antidilutive.

**Answer: D**

Options and warrants instruments that give the holders the right to purchase ordinary shares of the entity) issued by the reporting entity are assumed to be exercised at the beginning of the period or at time of issuance, if later. The proceeds are assumed to be from an issuance at the average market price for the period. The difference between 1) the shares issued and 2) the shares that would have been issued at the average market price is an issue for no consideration. If the options are in the money (exercise price is less than average market price), they are dilutive because 1) exceeds 2), and the excess will be added to the BEPS denominator. However, when the exercise price exceeds the average market price, the result is antidilutive.

**QUESTION: 153**

During the growth stage of a product's life cycle,

- A. The quality of products is poor.
- B. New product models and features are introduced.
- C. There is little difference between competing products.
- D. The quality of the products becomes more variable and products are less differentiated.

**Answer: B.**

In the growth stage, sales and profits increase rapidly, cost per customer decreases, customers are early adopters, new competitors enter an expanding market, new product models and features are introduced, and promotion spending declines or remains stable. The entity enters new market segments and distribution channels and attempts

to build brand loyalty and achieve the maximum share of the market. Thus, prices are set to penetrate the market, distribution channels are extended, and the mass market is targeted through advertising. The strategy is to advance by these means and by achieving economies of productive scale.

**QUESTION: 154**

In a product's life cycle, the first symptom of the decline stage is a decline in the

- A. Entity's inventory levels.
- B. Product's sales.
- C. Product's production cost
- D. Product's prices.

**Answer: B.**

The sales of most product types and brands eventually decrease permanently. This decline may be slow or rapid. This first symptom of the decline stage of a product's life cycle triggers such other effects as price cutting, narrowing of the product line, and reduction in promotion budgets.

**QUESTION: 155**

At the introduction stage of an innovative product, the profit growth is normally slow due to

- A. Expensive sales promotion.
- B. High competition.
- C A mass market
- D. Available alternatives.

**Answer: A**

The introduction stage is characterized by slow sales growth and lack of profits because of the high expenses of promotion and selective distribution to generate awareness of the product and encourage customers to try it. Thus, the per-customer cost is high. Competitors are few, basic versions of the product are produced, and higher-income customers (innovators) are usually targeted. Cost-plus prices are charged. They may initially be high to permit cost recovery when unit sales are low. The strategy is to infiltrate the market, plan for financing to cope with losses, build supplier relations, increase production and marketing efforts, and plan for competition.

**QUESTION: 156**

While auditing a marketing department, the internal auditor discovered that the product life cycle model was used to structure the marketing mix. Under such a philosophy, the price charged on a consistent basis for a specific product would probably be lowest during which life cycle stage?

- A. Introduction stage.
- B. Growth stage.
- C. Maturity stage.
- D. Decline stage.

**Answer: C**

During the maturity stage, competition is at its greatest and costs are at their lowest. Moreover, entities are engaged in competitive price-cutting measures, resulting in some of the lowest prices seen during a product's life cycle.

**QUESTION: 157**

While auditing a marketing department, the internal auditor discovered that the product life cycle model was used to structure the marketing mix. Under such a philosophy, the opportunity for cost reductions would be greatest in which stage of the life cycle?

- A. Introduction stage.
- B. Growth stage.
- C. Maturity stage.
- D. Decline stage.

**Answer: B**

During the growth stage, the opportunity for cost reductions is at its maximum because production volume is increasing at a high rate. Thus, fixed costs are being spread over more units of production, and the benefits of the learning curve are being realized.

**QUESTION: 158**

While auditing a marketing department, the internal auditor discovered that the product life cycle model was used to structure the marketing mix. The manager has asked the auditor for advice about increasing advertising of various products. During which stage of the life cycle would it be appropriate to advertise that the entity's product is the lowest price and best quality of all competitors?

- A. Introduction stage.
- B. Growth stage.
- C. Maturity stage.

D. Decline stage.

**Answer: C**

The maturity stage is the ideal time for advertising lower prices and superior quality because this is the period during a product's life when competition is greatest. Due to the availability of many substitutes, an entity has reasons to set itself apart. Because price and quality are both concerns of customers during the maturity stage, it is an ideal time for the entity to differentiate its product by advertising low prices and higher quality.

**QUESTION: 159**

Faced with 3 years of steadily decreasing profits despite increased sales and a growing economy, which of the following is the healthiest course of action for a chief executive officer to take?

- A. set a turnaround goal of significantly increasing profits within 2 months. Set clear short-term objectives for each operating unit that, together, should produce the turnaround.
- B. Reduce staff by 10% in every unit
- C. Classify all job functions as either a) adding value in the eyes of the customer such as production and sales) or b) not adding value in the eyes of the customer such as accounting and human resources)\_ Reduce staff in the non-value-adding functions by 20%\_
- D. Implement a plan to encourage innovation at all levels. Use early retirement and reemployment programs to trim staff size.

**Answer: D**

Organizational decline has been found to have the following characteristics: greater centralization, lack of long-term planning, reduced innovation, scapegoating, resistance to change, high turnover of competent leaders, low morale, nonprioritized downsizing, and conflict. Reversing these characteristics is the key to reversing organizational decline, for example, by encouraging innovation in all aspects of the organization's activities and by redeploying personnel.

**QUESTION: 160**

In which stage of an entity's development is it most likely to seek and obtain external equity financing in the form of venture capital?

- A. Formation.
- B. Rapid growth.
- C. Growth to maturity.
- D. Maturity and industry decline.

**Answer: B.**

At the rapid growth stage, if an entity is reasonably profitable, it will experience financing needs in excess of funds available either internally or from trade credit or bank credit. Additional debt financing on results in an unreasonable amount of financial leverage at this stage, and public equity financing ordinarily is not yet available. Hence, a rapidly growing entity is most likely to seek and obtain venture capital financing.

RST Corporation's Income Statement for Year 5 and Year 6

	Year 6	Year 5
Sales (all are credit)	US \$285,000	US \$200,000
Cost of goods sold	150,000	120,000
Gross profit	135,000	80,000
S and A expense	65,000	36,000
Profit bef. int. & inc. tax	70,000	44,000
Interest expense	3,000	3,000
Profit before income tax	67,000	41,000
Income tax expense	27,000	16,000
Profit	US \$ 40,000	US \$ 25,000

RST Corporation's Balance Sheets End of Year 5 and Year 6.

	Year 6	Year 5
<b>Assets</b>		
Current assets		
Cash	US \$ 5,000	US \$ 4,000
Financial assets held for trading	3,000	2,000
Accounts receivable (net)	16,000	14,000
Inventory	30,000	20,000
Total current assets	54,000	40,000
Noncurrent assets:		
Long-term investments	11,000	11,000
PP&E	80,000	70,000
Intangibles	3,000	4,000
Total assets	US \$148,000	US \$125,000
<b>Liabilities and Equity</b>		
Current liabilities:		
Accounts payable	US \$ 11,000	US \$ 7,000
Accrued payables	1,000	1,000
Total current liabilities	12,000	8,000
Bonds payable, 10%, due Year 12	30,000	30,000
Total liabilities	\$ 42,000	\$ 38,000
Equity:		
Ordinary shares, 2,400 shares, US \$10 par	\$ 24,000	\$ 24,000
Retained earnings	82,000	63,000
Total equity	106,000	87,000
Total liabilities and equity	US \$148,000	US \$125,000

The market value of RST's ordinary stock at the end of Year 6 was US \$100.00 per share.

**QUESTION: 161**

Based on a comparison of RST's times-interest-earned ratios in Year 5 and Year 6, what is a likely conclusion?

- A. RST's long-run solvency has declined.
- B. RST's long-run solvency has improved.
- C. RST's liquidity has improved.

D. RST's liquidity has declined.

**Answer: B**

The times-interest-earned ratio increased from 14.67 times in Year 5  $44,000 \div 3,000$  to 23.33 times in Year 6  $70,000 \div 3,000$ ). This increase signifies that RST has more profit available to meet the interest payments on its debt, and that long-run solvency has improved. Consequently, creditors will view RST's obligations as less risky.

An entity had the following opening and closing inventory balances during the current year:

	1/1	12/31
Finished goods	90,000	260,000
Raw materials	105,000	130,000
Work-in-progress	220,000	175,000

The following transactions and events occurred during the current year

300,000 of raw materials were purchased, of which 20,000 were returned because of defects.

600,000 of direct labor costs were incurred.

750,000 of production overhead costs were incurred.

**QUESTION: 162**

Without prejudice to your answer to any other question, assume that cost of goods sold for the current year ended December 31 is 2,000,000. Inventory turnover on total inventory for the entity would be

- A. 2.04 times.
- B. 3.54 times.
- C. 4.08 times.
- D. 4.82 times.

**Answer: C**

Inventory turnover is the ratio of cost of goods sold to the average inventory balance. The total average inventory is 490,000  $[(90,000 \text{ BFG} + 105,000 \text{ BRM} + 220,000 \text{ BWIP} + 260,000 \text{ EFG} + 130,000 \text{ ERM} + 175,000 \text{ EWIP}) \div 2]$ . Hence, total inventory turnover is 4.08 times  $2,000,000 \text{ assumed CGS} \div 490,000 \text{ average total inventory}$ ).

**Section 1: Sec One (163 to 288)**

**Details: Financial Accounting II**

**QUESTION: 163**

Using absorption costing, fixed manufacturing overhead costs are best described as



- A. Direct period costs.
- B. Indirect period costs.
- C. Direct product costs.
- D. Indirect product costs.

**Answer:** D

Using absorption costing, fixed manufacturing overhead is included in inventoriable product costs. Fixed manufacturing overhead costs are indirect costs because they cannot be directly traced to specific units produced.

**QUESTION:** 164

Many companies recognize three major categories of costs of manufacturing a product. These are direct materials, direct labor, and overhead. Which of the following is an overhead cost in the production of an automobile?

- A. The cost of small tools used in mounting tires on each automobile.
- B. The cost of the tires on each automobile.
- C. The cost of the laborers who place tires on each automobile.
- D. The delivery costs for the tires on each automobile.

**Answer:** A

The cost of small tools used in mounting tires cannot be identified solely with the manufacture of a specific automobile. This cost should be treated as factory overhead because it is identifiable with the production process.

**QUESTION:** 165

A company experienced a machinery breakdown on one of its production lines. As a consequence of the breakdown, manufacturing fell behind schedule, and a decision was made to schedule overtime to return manufacturing to schedule. Which one of the following methods is the proper way to account for the overtime paid to the direct laborers?

- A. The overtime hours times the sum of the straight-time wages and overtime premium entirely to manufacturing overhead.
- B. The overtime hours times the sum of the straight-time wages and overtime premium direct labor.
- C. The overtime hours times the overtime premium would be charged to repair and maintenance expense, and the overtime hours times the straight-time wages would be

treated as direct labor.

D. The overtime hours times the overtime premium would be charged to manufacturing overhead and the overtime hours times the straight-time wages would be treated as direct labor.

**Answer: D**

Direct labor costs are wages paid to labor that can feasibly be specifically identified with the production of finished goods. Factory overhead consists of all costs, other than direct materials and direct labor, that are associated with the manufacturing process. Thus, straight-time wages would be treated as direct labor; however, because the overtime premium cost is a cost that should be borne by all production, the overtime hours times the overtime premium should be charged to manufacturing overhead.

**QUESTION: 166**

A manufacturing firm produces multiple families of products requiring various combinations of different types of parts. The manufacturer has identified various cost pools. One of which consists of materials handling costs. This cost pool includes the wages and employee benefits of the workers involved in receiving materials, inspecting materials, storing materials in inventory, and moving materials to the workstations; depreciation and maintenance of materials handling equipment (e.g., forklift trucks); and costs of supplies used as well as other related costs. Of the following, the most appropriate cost driver for assigning materials handling costs to the various products most likely is

- A. Direct labor hours.
- B. Number of units produced.
- C. Number of vendors involved.
- D. Number of parts used.

**Answer: D**

Cost drivers should be related to the costs accumulated in cost pools. The number of parts used has a direct cause-and-effect relationship with materials handling costs. The more parts used, the more handling is involved.

**QUESTION: 167**

The allocation of general overhead costs to operating departments can be least justified in determining

- A. Income of a product or functional unit.
- B. Costs for making management's decisions.
- C. Costs for the federal government's cost-plus contracts

D. Income tax payable.

**Answer:** B.

In the short run, management decisions are made in reference to incremental costs without regard to fixed overhead costs because fixed overhead cannot be changed in the short run. Thus, the emphasis in the short run should be on controllable costs. For example, service department costs allocated as a part of overhead may not be controllable in the short run.

**QUESTION:** 168

A computer company charges indirect manufacturing costs to a project at a fixed percentage of a cost pool. This project is covered by a cost-plus government contract. Which of the following is an appropriate guideline for determining how costs are assigned to the pool?

- A. Establish separate pools for variable and fixed costs.
- B. Assign prime costs and variable administrative costs to the same pool.
- C. Establish a separate pool for each assembly line worker to account for wages.
- D. Assign all manufacturing costs related to the project to the same pool.

**Answer:** A

Cost pools are accounts in which a variety of similar costs are accumulated prior to allocation to cost objectives. The overhead account is a cost pool into which various types of overhead are accumulated prior to their allocation. Indirect manufacturing costs are an element of overhead allocated to a cost pool. Ordinarily, different allocation methods are applied to variable and fixed costs, thus requiring them to be separated. Establishing separate pools allows the determination of dual overhead rates. As a result, the assessment of capacity costs, the charging of appropriate rates to user departments, and the isolation of variances are facilitated.

**QUESTION:** 169

Which of the following is a product cost for a manufacturing company?

- A. Insurance on the corpor
- B. Property taxes on a fact
- C. Depreciation on a salesperson's vehicle.
- D. The salary of a sales manager.

**Answer:** B.

Product costs such as material, labor, and overhead attach to the product and are carried

in future periods if the revenue from the product is recognized in subsequent periods. Period costs are expensed immediately because no direct relationship between cost and revenue exists.

**QUESTION: 170**

In a traditional manufacturing operation, direct costs would normally include

- A. Machine repairs in an automobile factory.
- B. Electricity in an electronics plant.
- C. Wood in a furniture factory.
- D. Commissions paid to sales personnel.

**Answer: C**

Direct costs are readily identifiable with and attributable to specific units of production. Wood is a raw material (a direct cost) of furniture.

**QUESTION: 171**

An assembly plant accumulates its variable and fixed manufacturing overhead costs in a single cost pool, which is then applied to work in process using a single application base. The assembly plant management wants to estimate the magnitude of the total manufacturing overhead costs for different volume levels of the application activity base using a flexible budget formula. If there is an increase in the application activity base that is within the relevant range of activity for the assembly plant, which one of the following relationships regarding variable and is true?

- A. The variable cost per unit is constant, and the total fixed costs decrease.
- B. The variable cost per unit is constant, and the total fixed costs increase.
- C. The variable cost per unit and the total fixed costs remain constant.
- D. The variable cost per unit increases, and the total fixed costs remain constant.

**Answer: C**

Total variable cost changes when changes in the activity occur within the relevant range. The cost per unit for a variable cost is constant for all activity levels within the relevant range. Thus, if the activity volume increases within the relevant range, total variable costs will increase. A fixed cost does not change when volume changes occur in the activity level within the relevant range. If the activity volume increases within the relevant range, total fixed costs will remain unchanged.

**QUESTION: 172**

A company is attempting to determine if there is a cause-and-effect relationship between scrap value and output produced. The following exhibit presents the company's scrap data for the last fiscal year:

Scrap as a Percent of Standard Monetary Value of Output Produced		
Month	Standard Monetary Value of Output	Percent Scrap (%)
Nov Year 7	US \$1,500,000	4.5
Dec Year 7	1,650,000	2.5
Jan Year 8	1,600,000	3.0
Feb Year 8	1,550,000	2.5
Mar Year 8	1,650,000	1.5
Apr Year 8	1,500,000	4.0
May Year 8	1,400,000	2.5
Jun Year 8	1,300,000	3.5
Jul Year 8	1,650,000	5.5
Aug Year 8	1,000,000	4.5
Sep Year 8	1,400,000	3.5
Oct Year 8	1,600,000	2.5

The company's scrap value in relation to the standard monetary value of output produced appears to be

- A. A variable cost.
- B. A fixed cost.
- C. A semi-fixed cost
- D. Unrelated to the standard monetary value of output.

**Answer: D**

There is no systematic relationship between standard monetary units shipped and the percentage of scrap. A company wants to determine its marketing costs for budgeting purposes. Activity measures and costs incurred for 4 months of the current year are presented in the table below. Advertising is considered to be a discretionary cost. Salespersons are paid monthly salaries plus commissions. The sales force was increased from 20 to 21 individuals during the month of May.

	March	April	May	June
Activity measures:				
Sales orders	2,000	1,800	2,400	2,300
Units sold	55,000	60,000	70,000	65,000
Monetary sales	US \$1,150,000	US \$1,200,000	US \$1,330,000	US \$1,275,000
Marketing costs:				
Advertising	\$ 190,000	\$ 200,000	\$ 190,000	\$ 190,000
Sales salaries	20,000	20,000	21,000	21,000
Commissions	23,000	24,000	26,600	25,500
Shipping costs	93,000	100,000	114,000	107,000
Total costs	<u>US \$ 326,000</u>	<u>US \$ 344,000</u>	<u>US \$ 351,600</u>	<u>US \$ 343,500</u>

**QUESTION: 173**

Which of the following most appropriately describes the classification and behavior of shipping costs?

	<u>Classification</u>	<u>Behavior</u>
A.	Variable cost	US \$1.66 per unit sold
B.	Mixed cost	US \$16,000 per month plus \$1.40 per unit sold
C.	Mixed cost	US \$30,000 per month plus \$35.00 per sales order
D.	Mixed cost	US \$58,000 per month plus \$23.33 per sales order

**Answer: B.**

Using the high-low method, the variable and fixed costs for shipping can be calculated. The difference in cost levels divided by the difference in unit volume equals the variable cost per unit of US \$1.40 [ $(\$114,000 - \$93,000) / (70,000 - 55,000)$ ]. The variable cost for 70,000 units is US \$98,000 ( $70,000 \times \$1.40$ ). Subtracting the variable cost from total shipping cost results in the fixed cost of US \$16,000 ( $\$114,000 - \$98,000$ ). A company wants to determine its marketing costs for budgeting purposes. Activity measures and costs incurred for 4 months of the current year are presented in the table below. Advertising is considered to be a discretionary cost. Salespersons are paid monthly salaries plus commissions. The sales force was increased from 20 to 21 individuals during the month of May.

	<u>March</u>	<u>April</u>	<u>May</u>	<u>June</u>
Activity measures:				
Sales orders	2,000	1,800	2,400	2,300
Units sold	55,000	60,000	70,000	65,000
Monetary sales	US \$1,150,000	US \$1,200,000	US \$1,330,000	US \$1,275,000
Marketing costs:				
Advertising	\$ 190,000	\$ 200,000	\$ 190,000	\$ 190,000
Sales salaries	20,000	20,000	21,000	21,000
Commissions	23,000	24,000	26,600	25,500
Shipping costs	93,000	100,000	114,000	107,000
Total costs	<u>US \$ 326,000</u>	<u>US \$ 344,000</u>	<u>US \$ 351,600</u>	<u>US \$ 343,500</u>

**QUESTION: 174**

In relation to the monetary unit amount of sales, which of the following cost classifications is appropriate for advertising and sales salaries costs?

	<u>Advertising</u>	<u>Sales Salaries</u>
A.	Variable cost	Fixed cost
B.	Fixed cost	Variable cost
C.	Mixed cost	Mixed cost
D.	Fixed cost	Fixed cost

**Answer:** D

Both advertising and sales salaries should be classified as fixed costs. The advertising was constant for 3 of the 4 months and would be considered fixed in terms of monetary unit sales. Sales salaries also did not vary with monetary unit sales. A company manufactures and sells a single product. Planned and actual production in its first year of operation was 100,000 units. Planned and actual costs for that year were as

	<u>Manufacturing</u>	<u>Nonmanufacturing</u>
Variable	US \$600,000	US \$500,000
Fixed	400,000	300,000

The company sold 85,000 units of product at a selling price of US \$30 per unit.

**QUESTION:** 175

Using absorption costing, the company's operating profit was

- A. US \$750,000
- B. US \$900,000
- C. US \$975,000
- D. US \$1,020,000

**Answer:** B.

Under absorption costing, product costs include fixed and variable manufacturing costs. The unit product cost under absorption costing is US \$10 [ (\$600,000 + \$400,000) ÷ 100,000 units produced]. All nonmanufacturing costs are expensed in the period incurred. Thus, operating profit is US \$900,000.

Revenue (85,000 units × US \$30)	US \$2,550,000
Cost of goods sold (85,000 units × US \$10)	(850,000)
Nonmanufacturing costs (US \$500,000 + \$300,000)	(800,000)
Operating profit	<u>US \$ 900,000</u>

A company manufactures and sells a single product. Planned and actual production in its first year of operation was 100,000 units. Planned and actual costs for that year were as follow:

	<u>Manufacturing</u>	<u>Nonmanufacturing</u>
Variable	US \$600,000	US \$500,000
Fixed	400,000	300,000

The company sold 85,000 units of product at a selling price of US \$30 per unit.

**QUESTION: 176**

Using variable costing, the company's operating profit was

- A. US \$750,000
- B. US \$840,000
- C. US \$915,000
- D. US \$975,000

**Answer: B.**

Under variable costing, the product cost includes only variable manufacturing costs. All fixed costs are expensed in the period incurred. Unit product cost under variable costing is US \$6 (\$600,000 / 100,000 units produced).

Revenue (85,000 units × US \$30)	US \$2,550,000
Variable cost of goods sold (85,000 units × US \$6)	(510,000)
Variable nonmanufacturing costs	(500,000)
Contribution margin	US \$1,540,000
Fixed costs	(700,000)
Operating profit	<u>US \$ 840,000</u>

A and B. are autonomous divisions of a corporation. They have no beginning or ending inventories, and the number of units produced is equal to the number of units sold. Following is financial information relating to the two divisions:

	<u>Division A</u>	<u>Division B</u>
Sales	US \$150,000	US \$400,000
Other revenue	10,000	15,000
Direct materials	30,000	65,000
Direct labor	20,000	40,000
Variable factory overhead	5,000	15,000
Fixed factory overhead	25,000	55,000
Variable S&A expense	15,000	30,000
Fixed S&A expense	35,000	60,000
Central corporate expenses (allocated)	12,000	20,000

**QUESTION: 177**

What is the total contribution to corporate profits generated by Division A before allocation of central corporate expenses?



- A. US \$18,000
- B. US \$20,000
- C. US \$30,000
- D. US \$90,000

**Answer: C**

Division A's total contribution to corporate profits includes everything except the central corporate expense allocation. Thus, the total contribution is US \$311,000 (\$150,000 sales + \$10,000 other revenue - \$30,000 direct materials - \$20,000 direct labor - \$5,000 variable overhead - \$25,000 fixed overhead - \$15,000 variable S & A expense - \$35,000 fixed S & A expense).

	Division A	Division B
Sales	US \$150,000	US \$400,000
Other revenue	10,000	15,000
Direct materials	30,000	65,000
Direct labor	20,000	40,000
Variable factory overhead	5,000	15,000
Fixed factory overhead	25,000	55,000
Variable S&A expense	15,000	30,000
Fixed S&A expense	35,000	60,000
Central corporate expenses (allocated)	12,000	20,000

A and B are autonomous divisions of a corporation. They have no beginning or ending inventories, and the number of units produced is equal to the number of units sold. Following is financial information relating to the two divisions:

**QUESTION: 178**

What is the contribution margin of Division B?

- A. US \$150,000
- B. US \$205,000
- C. US \$235,000
- D. US \$265,000

**Answer: D**

The contribution margin equals revenue minus variable costs. Thus, Division B's contribution margin is US \$265,000 (\$400,000 sales + \$15,000 other revenue - \$65,000 direct materials - \$40,000 direct labor - \$15,000 variable overhead - \$30,000 variable S & A expense).

**QUESTION: 179**

During its first year of operations, a company produced 275,000 units and sold 250,000 units. The following costs were incurred during the year:

Variable costs per unit:	
Direct materials	US \$15.00
Direct labor	10.00
Manufacturing overhead	12.50
Selling and administrative	2.50
Total fixed costs:	
Manufacturing overhead	US \$2,200,000
Selling and administrative	US \$1,375,000

The difference between operating profit calculated on the absorption-costing basis and on the variable-costing basis is that absorption-costing operating profit is

- A. US \$200,000 greater.
- B. US \$225,000 greater.
- C. US \$325,000 greater.
- D. US \$62,500 less.

**Answer: A**

Absorption-costing operating profit will exceed variable-costing operating income because production exceeds sales, resulting in a deferral of fixed manufacturing overhead in the inventory calculated using the absorption method. The difference of US \$200,000 is equal to the fixed manufacturing overhead per unit ( $\text{US } \$2,200,000 - 275,000 = \text{US } \$8.00$ ) times the difference between production and sales ( $275,000 - 250,000 = 25,000$ , which is the inventory change in units).

**QUESTION: 180**

A manufacturing company employs variable costing for internal reporting and analysis purposes. However, it converts its records to absorption costing for external reporting. The Accounting Department always reconciles the monthly operating income figures to assure that no errors have occurred in the conversion. The fixed manufacturing overhead cost per unit was based on the planned level of production of 480,000 units. Financial data for the year are presented below:

	<u>Budget</u>	<u>Actual</u>
Sales (in units)	495,000	510,000
Production (in units)	480,000	500,000
	<u>Variable Costing</u>	<u>Absorption Costing</u>
Variable costs	US \$10.00	US \$10.00
Fixed manufacturing overhead	0	6.00
Total unit manufacturing costs	<u>US \$10.00</u>	<u>US \$16.00</u>

The difference between the operating income calculated under the variable costing method and the operating income calculated under the absorption costing method would be

- A. US \$57,600
- B. US \$60,000
- C. US \$90,000
- D. US \$120,000

**Answer: B**

The difference between variable costing and absorption costing is that the former treats fixed manufacturing overhead as a period cost. The latter method treats it as a product cost. Given that sales exceeded production, both methods expense all fixed manufacturing overhead incurred during the year. However, 10,000 units (510,000 sales - 500,000 production) manufactured in a prior period were also sold. These units presumably were recorded at US \$10 under variable costing and US \$16 under absorption costing. Consequently, absorption costing operating income is US \$60,000 (10,000 units \$6) less than that under variable costing.

**QUESTION: 181**

When comparing absorption costing with variable costing, which of the following statements is not true?

- A. Absorption costing enables managers to increase operating profits in the short run by increasing inventories.
- B. When sales volume is more than production volume, variable costing will result in higher operating profit
- C. A manager who is evaluated based on variable costing operating profit would be tempted to increase production at the end of a period in order to get a more favorable review.
- D. Under absorption costing, operating profit is a function of both sales volume and production volume.

**Answer: C**

Absorption (full) costing is the accounting method that considers all manufacturing costs as product costs. These costs include variable and fixed manufacturing costs whether direct or indirect. Variable (direct) costing considers only variable manufacturing costs to be product costs, i.e., inventoriable. Fixed manufacturing costs are considered period costs and are expensed as incurred. If production is increased without increasing sales, inventories will rise. However, all fixed costs associated with production will be an expense of the period under variable costing. Thus, this action will not artificially increase profits and improve the manager's review.

**QUESTION: 182**

Which one of the following is the best characteristic concerning the capital budget? The capital budget is a n)

- A. Plan to ensure that there are sufficient funds available for the operating needs of the company.
- B. Exercise that sets the long-range goals of the company including the consideration of external influences caused by others in the market.
- C. Plan that results in the cash requirements during the operating cycle.
- D. Plan that assesses the long-term needs of the company for plant and equipment purchases.

**Answer: D**

Capital budgeting is the process of planning expenditures for long-lived assets. It involves choosing among investment proposals using a ranking procedure. Evaluations are based on various measures involving rate of return on investment.

**QUESTION: 183**

Everything else being equal, the internal rate of return (IRR) of an investment project will be lower if

- A. The investment cost is lower.
- B. Cash inflows are received later in the life of the project
- C. Cash inflows are larger.
- D. The project has a shorter payback period.

**Answer: B.**

The IRR is the discount rate at which the net present value is zero. Because the present value of a dollar is higher the sooner it is received, projects with later cash flows will

have lower net present values for any given discount rate than will projects with earlier cash flows, if other factors are constant. Hence, projects with later cash flows will have a lower IRR. A company that annually reviews its investment opportunities and selects appropriate capital expenditures for the coming year is presented with two projects, called Project A and Project B. Best estimates indicate that the investment outlay for Project A is US \$1 million and for Project B is US \$1 million. The projects are considered to be equally risky. Project A is expected to generate cash inflows of US \$40,000 at the end of each year for 2 years. Project B is expected to generate cash inflows of US \$700,000 at the end of the first year and US \$500,000 at the end of the second year. The company has a cost of capital of 8%.

**QUESTION: 184**

If the net present value (NPV) of Project A is known to be higher than the NPV of Project B, it can be concluded that

- A. The internal rate of return (IRR) of Project A will definitely be higher than the IRR of Project B
- B. The IRR of Project A will definitely be lower than the IRR of Project B
- C. The ranking of IRRs is indeterminate based on the information provided
- D. The payback period for Project A is definitely shorter than the payback period for Project B.

**Answer: C**

The IRR is the discount rate at which the net present value is zero. The NPV is the present value of future cash flows minus the present value of the investment. Because of a possible difference in the scale of the projects and other factors, a higher NPV does not necessarily result in a higher IRR. A company that annually reviews its investment opportunities and selects appropriate capital expenditures for the coming year is presented with two projects, called Project A and Project B. Best estimates indicate that the investment outlay for Project A is US \$30,000 and for Project B is US \$1 million. The projects are considered to be equally risky. Project A is expected to generate cash inflows of US \$40,000 at the end of each year for 2 years. Project B is expected to generate cash inflows of US \$700,000 at the end of the first year and US \$500,000 at the end of the second year. The company has a cost of capital of 8%.

**QUESTION: 185**

If Projects A and B are mutually exclusive, which of the following statements is true?

- A. The company should undertake Project A only.
- B. The company should undertake Project B only.
- C. The company should undertake both projects.

D The company should not undertake either project

**Answer:** B.

For two mutually exclusive projects, the company should undertake the project with the highest positive net present value. Project B has a higher NPV than Project A. The NPVs of both projects are calculated using the firm's 8% cost of capital as follows.

$$\begin{aligned}
 \text{NPV of Project A} &= \text{US } \$(-30,000) + \frac{\$40,000}{(1.08)} + \frac{\$40,000}{(1.08)^2} \\
 &= \text{US } \$41,331 \\
 \text{NPV of Project B} &= \text{US } \$(-1,000,000) + \frac{\$700,000}{(1.08)} + \frac{\$500,000}{(1.08)^2} \\
 &= \text{US } \$76,816
 \end{aligned}$$

A company that annually reviews its investment opportunities and selects appropriate capital expenditures for the coming year is presented with two projects, called Project A and Project B. Best estimates indicate that the investment outlay for Project A is US \$30,000 and for Project B is US \$1 million. The projects are considered to be equally risky. Project A is expected to generate cash inflows of US \$40,000 at the end of each year for 2 years. Project B is expected to generate cash inflows of US \$700,000 at the end of the first year and US \$500,000 at the end of the second year. The company has a cost of capital of 8%.

**QUESTION:** 186

If Projects A and B are independent, which of the following statements is true?

- A. The company should undertake Project A only.
- B. The company should undertake Project B only.
- C. The company should undertake both projects.
- D. The company should not undertake either project.

**Answer:** C

Independent projects are those whose cash flows are not affected by the acceptance or nonacceptance of other projects. The company must decide whether to accept or to reject each of the projects. Because both projects have a positive NPV calculated using the firm's 8% cost of capital, both should be accepted. A firm with an 8% cost of capital is considering the following projects on January 1, Year 1):

	January 1, Year 1 Cash Outflow (000s Omitted)	December 31, Year 5 Cash Inflow (000s Omitted)	Project Internal Rate of Return
Project A	US \$3,500	US \$7,400	16%
Project B	4,000	9,950	?

Present Value of US \$1 Due at the End of "N" Periods							
N	12%	14%	15%	16%	18%	20%	22%
4	.6355	.5921	.5718	.5523	.5158	.4823	.4230
5	.5674	.5194	.4972	.4761	.4371	.4019	.3411
6	.5066	.4556	.4323	.4104	.3704	.3349	.2751

**QUESTION: 187**

Using the net present value method, project A's net present value is

- A. US \$ 316,920)
- B. US \$ 265,460)
- C. US \$0
- D. US \$316,920

**Answer: B.**

The cash flow at December 31 of Year 5 is 5 years from the present cash outflow, and the net present value method uses the firm's cost of capital of 18%. The present value factor for 18% for 5 years is .4371, and US \$7,400,000 multiplied by .4371 equals US \$3,234,540, which is US \$265,460 less than the present cash outflow of US \$3,500,000.

	January 1, Year 1 Cash Outflow (000s Omitted)	December 31, Year 5 Cash Inflow (000s Omitted)	Project Internal Rate of Return
Project A	US \$3,500	US \$7,400	16%
Project B	4,000	9,950	?

Present Value of US \$1 Due at the End of "N" Periods							
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5	.5674	.5194	.4972	.4761	.4371	.4019	.3411
6	.5066	.4556	.4323	.4104	.3704	.3349	.2751

**QUESTION: 188**

Project B's internal rate of return is closest to

- A. 15%
- B. 18%
- C. 20%
- D. 22%

**Answer: C**

Twenty percent is the rate of return that equates the cash inflows with the cash outflows. The present value of 20% for 5 years is .4019, which multiplied by US \$9,950,000 equals US \$3,998,905. Therefore, the net present value of the project approximates 0 using the 20% rate.

**QUESTION: 189**

The capital budgeting model that is generally considered the best model for long-range decision making is the

- A. Payback model.
- B. Accounting rate of return model.
- C. Unadjusted rate of return model\_
- D. Discounted cash flow model.

**Answer: D**

The capital budgeting methods that are generally considered the best for long-range decision making are the internal rate of return and net present value methods. These are both discounted cash flow methods.

**QUESTION: 190**

When evaluating projects, breakeven time is best described as

- A. Annual fixed costs - monthly contribution margin.
- B. Project investment - annual net cash inflows.
- C. The point where cumulative cash inflows on a project equal total cash outflows.
- D. The point at which discounted cumulative cash inflows on a project equal discounted total cash outflows.

**Answer: D**

Breakeven time is a capital budgeting tool that is widely used to evaluate the rapidity of new product development. It is the period required for the discounted cumulative cash inflows for a project to equal the discounted cumulative cash outflows. The concept is similar to the payback period, but it is more sophisticated because it incorporates the time



value of money. It also differs from the payback method because the period covered begins at the outset of a project, not when the initial cash outflow occurs.

**QUESTION: 191**

A characteristic of the payback method (before taxes) is that it

- A. Incorporates the time value of money.
- B. Neglects total project profitability.
- C. Uses accrual accounting inflows in the numerator of the calculation.
- D. Uses the estimated expected life of the asset in the denominator of the calculation.

**Answer: B.**

The payback method calculates the number of years required to complete the return of the original investment. This measure is computed by dividing the net investment required by the average expected cash flow to be generated, resulting in the number of years required to recover the original investment. Payback is easy to calculate but has two principal problems: it ignores the time value of money, and it gives no consideration to returns after the payback period. Thus, it ignores total project profitability.

**QUESTION: 192**

When ranking two mutually exclusive investments with different initial amounts, management should give first priority to the project

- A. That generates cash flows for the longer period of time.
- B. Whose net after-tax flows equal the initial investment.
- C. That has the greater accounting rate of return.
- D. That has the greater profitability index.

**Answer: D**

The profitability index (excess present value) index facilitates the comparison of investments that have different initial costs. The profitability index equals the present value of future net cash inflows divided by the initial cash investment. The investment with the greater profitability index will be the preferred investment. However, if investments are mutually exclusive, the net present value method may be the better way of ranking project. The excess present value index indicates the benefit return per dollar invested but does not consider the alternative possibilities for unused funds. Thus, the smaller, of the mutually exclusive projects may have the higher NPV but the incremental investment in the larger project may make it the better choice. For example, a US \$8,000,000 project may be a better use of funds than a combination of a US \$6,000,000 project with a higher NPV and the best alternative use of the remaining US \$2,000,000. A company has the following

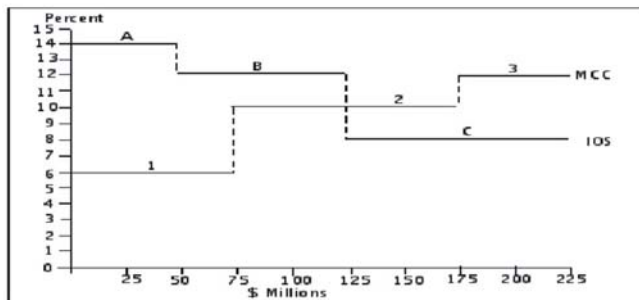
three investment projects available:

Project	Cost	Internal Rate of Return
A	US \$ 50 million	14%
B	US \$ 75 million	12%
C	US \$125 million	8%

The company has a 40% debt and 60% equity capital structure. Each monetary unit of investment funds will be raised in these proportions (.40 of debt and .60 of equity). The marginal cost of financing increases with the amount of new funds raised, as follows:

Interval	Amount Raised	Weighted-Average Cost of Capital
1	First US \$ 75 million	6%
2	Next US \$100 million	10%
3	Over US \$175 million	12%

These investment opportunities and financing costs are shown in the graph below:



MCC=Marginal cost of capital

IOS=Investment opportunity schedule

### QUESTION: 193

Assume that the optimal capital budget for the company is US \$150 million. The marginal cost of capital and the appropriate discount rate to use in evaluating investment proposals for this company would be

- A. 6%
- B. 8%
- C. 10%
- D. 12%

### Answer: C

The appropriate discount rate (the cost of capital used in capital budgeting) theoretically

is determined at the intersection of the IOS and MCC schedules. This intersection is at an r..1r~:0 of IC I% and an optimal capital budget of US \$125 million. However, if the optimal capital budget is assumed to be US \$150 million, the company is still in the second interval of the MCC schedule. The marginal cost of financing in this part of the schedule is 10%.

**QUESTION: 194**

One of the primary advantages of budgeting is that it

- A. Does not take the place of management and administration.
- B. Bases the profit plan on estimates.
- C. Is continually adapted to fit changing circumstances.
- D. Requires departmental managers to make plans in conjunction with the plans of other interdependent departments.

**Answer: D**

A budget is a quantitative model of a plan of action developed by management. A budget functions as an aid to planning, coordination, and control. Thus, a budget helps management to allocate resources efficiently and to ensure that subunit goals are congruent with those of other subunits and of the organization.

**QUESTION: 195**

While an operating budget is a key element in planning and control, it is not likely to

- A. Establish a commitment of company resources.
- B. Set out long-range, strategic concepts.
- C. Integrate organizational activities.
- D. Provide subsidiary planning information.

**Answer: B.**

Operating budgets seldom set out long-range strategic concepts because they usually deal with the quantitative allocation of people and resources. Strategic concepts are overall goals for the organization and are almost always stated in words.

**QUESTION: 196**

The major appeal of zero-based budgeting is that it

- A. Solves the problem of measuring program effectiveness.
- B. Relates performance to resource inputs by an integrated planning and resource-allocation process.
- C. Reduces significantly the time required to review a budget.
- D. Deals with some of the problems of the incremental approach to budgeting.

**Answer: D**

The traditional approach to budgeting is to merely increase last year's figures by a given percentage or increment. Zero-based budgeting divides programs into packages of goals, activities, and required resources. The cost of each package is then calculated afresh, without regard to previous performance.

**QUESTION: 197**

The major objectives of any budget system are to

- A Define responsibility centers, provide a framework for performance evaluation, and promote communication and coordination among organization segments.
- B. Define responsibility centers, facilitate the fixing of blame for missed budget predictions, and ensure goal congruence between superiors and subordinates.
- C. Foster the planning of operations, provide a framework for performance evaluation, and promote communication and coordination among organization segments.
- D Foster the planning of operations, facilitate the fixing of blame for missed budget predictions, and ensure goal congruence between superiors and subordinates.

**Answer: C**

A budget is a realistic plan for the future expressed in quantitative terms. The process of budgeting forces a company to establish determine the resources necessary to achieve those goals, and anticipate future difficulties in their investment. A budget is also a control tool because it establishes standards and facilitates comparison of actual and budgeted performance. Because a budget establishes standards and accountability, it motivates improved performance by highlighting the work of effective managers. Moreover, the nature of the budgeting process fosters communications of goals to company subunits and coordination of their efforts. Budgeting activities by entities within the company must be coordinated because they are interdependent. Thus, the sales budget is a necessary input to the formulation of the production budget. In turn, production requirements must be known before purchases and expense budgets can be developed and all other budgets must be completed before preparation of the cash budget.

**QUESTION: 198**

A company prepares a flexible budget each month for manufacturing costs. Formulas have been developed for all costs within a relevant range of 5,000 to 15,000 units per month. The budget for electricity (a semivariable cost) is US \$19,800 at 9,000 units per month, and US \$21,000 at 10,000 units per month. How much should be budgeted for electricity for the coming month if 12,000 units are to be produced?

- A. US \$26,400
- B. US \$25,200
- C. US \$23,400
- D. US \$22,200

**Answer: C**

A flexible budget consists of a fixed cost component and a variable cost component. The fixed cost component can be expected to remain constant throughout the budget's relevant range. The variable cost component, however, will change at a constant rate within the budget's range. The increase in budgeted cost of US \$1,200 [ $\$21,000 - \$19,800$ ] per 1,000 units of production can therefore be calculated as the variable cost per unit of US \$1.20 [ $\$1,200 / 1,000$ ]. The total fixed costs of US \$9,000 [ $\$19,800 - (\$1.20 \times 9,000)$ ] can then be used to determine the total cost of using 12,000 units of electricity [ $\$9,000 \text{ FC} + 12,000 \times \$1.20$ ].

**QUESTION: 199**

There are many different budget techniques or processes that business organizations can employ. One of these techniques or processes is zero-based budgeting, which is

- A. Budgeting from the ground up as though the budget process were being initiated for the first time.
- B. Budgeting for cash inflows and outflows to time investments and borrowings in a way to maintain a bank account with a minimum balance.
- C. Using the prior year's budget as a base year and adjusting it based on the experiences of the prior year and the expectations for the coming year
- D. Developing budgeted costs from clear-cut measured relationships between inputs and outputs

**Answer: A**

Zero-based budgeting (ZBB) is a planning process in which each manager must justify a department's entire budget every year (or period). Under ZBB, a manager must build the budget every year from a base of zero. All expenditures must be justified regardless of the variances from previous years' budgets. The objective is to encourage periodic reexamination of all costs in the hope that some can be reduced or eliminated. Different levels of service (work effort) are evaluated for each activity, measures of work and performance are established, and activities are ranked (prioritized) according to their

importance to the entity. For each budgetary unit, decision packages are prepared that describe various levels of service that may be provided, including at least one lower than the current one.

**QUESTION: 200**

The major feature of zero-based budgeting (ZBB) is that it

- A. Takes the previous year's budgets and adjusts them for inflation.
- B. Questions each activity and determines whether it should be maintained as it is, reduced, or eliminated.
- C. Assumes all activities are legitimate and worthy of receiving budget increases to cover any increased costs.
- D. Focuses on planned capital outlays for property, plant, and equipment.

**Answer: B.**

ZBB. is a planning process in which each manager must justify his/her department's full budget for each period. The purpose is to encourage periodic reexamination of all costs in the hope that some can be reduced or eliminated.

**QUESTION: 201**

A manufacturing firm has certain peak seasons; namely the Christmas season, the summer season, and the last 2 weeks of February. During these periods of increased output, the firm leases additional production equipment and hires additional temporary employees. Which of the following budget techniques would best fit this firm's needs?

- A. Flexible budgeting.
- B. Static budgeting.
- C. Zero-based budgeting.
- D. Project budgeting.

**Answer: A**

A flexible budget is a series of several budgets prepared for many levels of sales. It is designed to allow adjustment of the budget to the actual level of activity before comparing the budgeted activity with actual results. A firm with peak seasons may prefer flexible budgeting because of its difficulties in predicting the activity level.

**QUESTION: 202**

The master budget

- A. Shows forecasted and actual results.
- B. Reflects controllable costs only.
- C. Can be used to determine manufacturing cost variances.
- D. Contains the operating budget.

**Answer: D**

All other budgets are subsets of the master budget. Thus, quantified estimates by management from all functional areas are contained in the master budget. These results are then combined in a formal quantitative model recognizing the organization's objectives, inputs, and outputs.

**QUESTION: 203**

Comparing actual results with a budget based on achieved volume is possible with the use of a

- A. Monthly budget.
- B. Master budget.
- C. Rolling budget.
- D. Flexible budget.

**Answer: D**

A flexible budget is essentially a series of several budgets prepared for many levels of sales or production. At the end of the period, management can compare actual costs or performance with the appropriate budgeted level in the flexible budget. New columns can quickly be made by interpolation or extrapolation, if necessary. A flexible budget is designed to allow adjustment of the budget to the actual level of activity before comparing the budgeted activity with actual results.

**QUESTION: 204**

The procedure employed in zero-based budgeting is to

- A. Budget from the ground up whereby every proposed expenditure for every unit is reviewed as though the budget was being prepared for the very first time.
- B. Review the prior period's budget along with actual results for that period and the attainments for the coming period to develop more realistic budget amounts for the coming period.
- C. Require managers to establish priorities by including a description of what activities or changes would occur if the budget were increased and decreased by a fixed percentage amount.
- D. Ascertain the outputs that are desired and work backward to determine the amount of inputs that will be required to generate the desired outputs.

**Answer: A**

Zero-based budgeting treats the budget as if it were being initiated for the first time. Thus, all costs are reexamined each period. Beginning with the smallest budgetary subunits, managers must determine objectives, operations, and cost for all activities. Alternative methods of conducting each activity are considered, different levels of service are evaluated for each activity, means of measuring work and performance are determined, and activities are ranked in order of importance to the organization.

**QUESTION: 205**

A flexible budget is a quantitative expression of a plan that

- A. Is developed for the actual level of output achieved for the budget period.
- B. Is comprised of the budgeted income statement and its supporting schedules for a budget period.
- C. Focuses on the costs of activities necessary to produce and sell products and services for a budget period.
- D. Project costs on the basis of future improvements in existing practices and procedures during a budget period.

**Answer: A**

A flexible budget is a series of budgets prepared for many levels of activity. It is designed to allow adjustment of the budget to the actual level of activity before comparing the budgeted activity with actual results.

**QUESTION: 206**

A master budget

- A. Shows forecasted and actual results.
- B. Contains only controllable costs.
- C. Can be used to determine manufacturing cost variances.
- D. Contains the operating budget.

**Answer: D**

The operating budget sequence is part of the master budget process that begins with the sales budget and culminates in the pro forma income statement.

**QUESTION: 207**



Individual budget schedules are prepared to develop an annual comprehensive or master budget. The budget schedule that provides the necessary input data for the direct labor budget is the

- A. Sales forecast
- B. Raw materials purchases budget.
- C. Schedule of cash receipts and disbursements.
- D. Production budget.

**Answer: D**

A master budget typically begins with the preparation of a sales budget. The next step is to prepare a production budget. Once the production budget has been completed, the next step is to prepare the direct labor, raw material, and overhead budgets. Thus, the production budget provides the input necessary for the completion of the direct labor budget.

**QUESTION: 208**

When sales volume is seasonal in nature, certain items in the budget must be coordinated. The three most significant items to coordinate in budgeting seasonal sales volume are

- A. Production volume, finished goods inventory, and sales volume.
- B. Direct labor hours, work-in-process inventory, and sales volume.
- C. Raw material inventory, direct labor hours, and manufacturing overhead costs.
- D. Raw material inventory, work-in-process inventory, and production volume.

**Answer: A**

The most difficult items to coordinate in any budget, particularly for a seasonal business, are production volume, finished goods inventory, and sales. Budgets usually begin with sales volume and proceed to production volume, but the reverse is sometimes used when production is more of an issue than generation of sales. Inventory levels are also important because sales cannot occur without inventory, and the maintenance of high inventory levels is costly. The Raymar Company is preparing its cash budget for the months of April and May. The firm has established a US \$200,000 line of credit with its bank at a 12% annual rate of interest on which borrowings for cash deficits must be made in US\$. increments. There is no outstanding balance on the line of credit loan on April 1 Collections. 50% of the current month's sales budget and 50% of the Principal repayments are to be made in any month in which previous month's sales budget. there is a surplus of cash. Interest is to be paid monthly. If• Accounts Payable Disbursements. 75% of the current month's there are no outstanding balances on the loans. Raymarwill invest any cash in excess of its desired end-of-month cash accounts payable budget and 25% of the previous month's accounts payable budget. balance in

U.S Treasury bills. Raymar intends to maintain a minimum balance of US \$100,000 at the end of each month by either borrowing for deficits below the minimum balance or investing any excess cash. Expected monthly collection and disbursement patterns are shown in the columns to the right.

	<u>Budget Information</u>		
	<u>March</u>	<u>April</u>	<u>May</u>
Sales	US \$40,000	US \$50,000	US \$100,000
Accounts payable	30,000	40,000	40,000
Payroll	60,000	70,000	50,000
Other disbursements	25,000	30,000	10,000

**QUESTION: 209**

In May, Raymar will be required to

- A. Repay US \$20,000 principal and pay US \$1,000 interest
- B. Repay US \$90,000 principal and pay US \$100 interest
- C. Pay US \$900 interest
- D. Borrow an additional US \$20,000 and pay US \$1,000 interest.

**Answer: D**

The company will have to borrow US \$100,000 in April, which means that interest will have to be paid in May at the rate of 1% per month (12% annual rate). Consequently, interest expense is US \$1,000 ( $\$100,000 \times 1\%$ ). May sales (50%) + April sales (50%) = \$75,000. Disbursements in May: Accounts Payable (75% of April payables) + \$40,000 April payables (25%) = \$70,000. In addition to the May accounts payable disbursements, payroll and other disbursements are US \$60,000, bringing total disbursements to US \$130,000 ( $\$70,000 + \$60,000$ ). Thus, disbursements exceed receipts by US \$55,000 ( $\$130,000 - \$75,000$ ). However, cash has a beginning surplus balance of US \$7,500 ( $\$100,000$  April loan -  $\$92,500$  negative cash flow for April). As a result, the company needs to borrow an additional US \$47,500 to eliminate its cash deficit. Given the requirement that loans be in US \$10,000 increments, the May loan must be for US \$57,500. The Raymar Company is preparing its cash budget for the months of April and May. The firm has established a line of credit with its bank at a 12% annual rate of Accounts Payable Disbursements. 75% of the current month's interest on which borrowings for cash deficits must be made in US\$. increments. There is no outstanding balance on the accounts payable budget and 25% of the previous month's accounts payable budget. line of credit loan on April 1. Principal repayments are to be made in any month in which there is a surplus of cash. Interest is to be paid monthly. If there are no outstanding balances on the loans. Raymar will invest any cash in excess of its desired end-of-month cash balance in U.S. Treasury bills. Raymar intends to maintain a minimum balance of US \$100,000 All other disbursements occur in the month in which they are budgeted.

<u>Budget Information</u>			
	<u>March</u>	<u>April</u>	<u>May</u>
Sales	US \$40,000	US \$50,000	US \$100,000
Accounts payable	30,000	40,000	40,000
Payroll	60,000	70,000	50,000
Other disbursements	25,000	30,000	10,000

**QUESTION: 210**

In April, Raymar's budget will result in

- A. US \$45,000 in excess cash.
- B. A need to borrow US \$50,000 on its line of credit for the cash deficit.
- C. A need to borrow US \$100,000 on its line of credit for the cash deficit.
- D. A need to borrow US \$90,000 on its line of credit for the cash deficit.

**Answer: C**

Assuming Raymar maintained a US \$100,000 cash balance at the end of March, the amount to be borrowed or invested in April is the difference between cash receipts and disbursements. April's cash collections are US \$45,000 [ \$50,000 April sales x 50%) + \$40,000 March sales x 50%)]. Disbursements for accounts payable are US \$37,500 [ \$40,000 April payables x 75%) + \$30,000 March payables x 25%)]. In addition to the accounts payable disbursements, payroll and other disbursements will require an additional US \$100,000. Hence, total disbursements are estimated to be US \$137,500. The net negative cash flow amount to be borrowed to reach the required minimum cash balance of US \$100,000 is US \$92,500 (\$137,500 - \$45,000). Because the line of credit must be drawn upon in US \$10,000 increments, the loan must be for US \$100,000.

**QUESTION: 211**

Butteco has the following cost components for 100,000 units of product for the year just ended:

Raw materials	US \$200,000
Direct labor	100,000
Manufacturing overhead	200,000
Selling/administrative expense	150,000

All costs are variable except for US \$100,000 of manufacturing overhead and US \$100,000 of selling and administrative expenses. The total costs to produce and sell 110,000 units during the year are

- A. US \$650,000
- B. US \$715,000

- C. US \$695,000  
D. US \$540,000

**Answer: C**

Raw materials unit costs are strictly variable at US \$2 (\$200,000 / 100,000 units). Similarly, direct labor has a variable unit cost of US \$1 (\$100,000 / 100,000 units). The US \$200,000 of manufacturing overhead for 100,000 units is 50%. The variable unit cost is US \$1. Selling costs are US \$100,000 fixed and US \$1 variable for production. Fixed costs are US \$200,000. At a production level of 110,000 units, variable costs are US \$495,000 (110,000 units x \$4.50). Hence, total costs are US \$ 695,000 (\$495,000 + \$200,000).

**QUESTION: 212**

Barnes Corporation expected to sell 150,000 board games during the month of November, and the company's master budget contained the following data related to the sale and production of these games:

Revenue	US \$2,400,000
Cost of goods sold	
Direct materials	675,000
Direct labor	300,000
Variable overhead	450,000
Contribution	\$ 975,000
Fixed overhead	250,000
Fixed selling/administration	500,000
Operating income	<u>US \$ 225,000</u>

Actual sales during November were 180,000 games. Using a flexible budget, the company expects the operating income for the month of November to be

- A. US \$225,000  
B. US \$270,000  
C. US \$420,000  
D. US \$510,000

**Answer: C**

Revenue of US \$2,400,000 reflects a unit selling price of US \$16 (\$2,400,000 / 150,000 games). The contribution margin is US \$975,000, or US \$6.50 per game (\$975,000 / 150,000 games). Thus, unit variable cost is US \$9.50 (\$16 - \$6.50). Increasing sales will result in an increased contribution margin of US \$195,000 (30,000 x \$6.50). Assuming no additional fixed costs, net income will increase to US \$420,000 (\$225,000 originally reported + \$195,000).

**QUESTION: 213**

A company's budget for next year contains the following information:

	<u>Units</u>
Beginning finished goods inventory	85
Beginning work-in-process in equivalent units	10
Desired ending finished goods inventory	100
Desired ending work-in-process in equivalent units	40
Projected sales for next year	1,800

How many equivalent units should the company plan to produce next year?

- A. 1,800
- B. 1,565
- C. 1,815
- D. 1,845

**Answer: D**

Needed for sales	1,800
Needed for ending inventory	<u>100</u>
Total finished units needed	1,900
Minus beginning inventory	<u>85</u>
Finished units needed	<u>1,815</u>
The units to be produced equal 1,845:	
Finished units needed	1,815
Needed for ending inventory	<u>40</u>
Total units in process	1,855
Minus beginning WIP inventory	<u>10</u>
Units to be produced	<u>1,845</u>

**QUESTION: 214**

A company has budgeted sales of 24,000 finished units for the forthcoming 6-month period. It takes 4 pounds of direct materials to make one finished unit. Given the following:

	<u>Finished units</u>	<u>Direct materials</u> <u>(pounds)</u>
Beginning inventory	14,000	44,000
Target ending inventory	12,000	48,000

How many pounds of direct materials should be budgeted for purchase during the 6-month period?

- A. 40,000
- B. 88,000
- C. 92,000
- D. 96,000

**Answer: C**

Required production of finished units is 22,000 units target ending inventory of 12,000 + sales of 24,000 – beginning inventory of 14,000 lb). Thus, 88,000 pounds of direct materials (22,000 x 4 lb. per unit) must be available. Required purchases of direct materials equal 92,000 pounds (target ending inventory of 48,000 + usage of 88,000 – beginning inventory of 44,000).

**QUESTION: 215**

The price that one division of a company charges another division for goods or services provided is called the

- A. Market price
- B. Transfer price.
- C. Outlay price
- D. Distress price.

**Answer: B.**

A transfer price is the price charged by one segment of an organization for a product or service supplied to another segment of the same organization.

**QUESTION: 216**

A limitation of transfer prices based on actual cost is that they

- A. Charge inefficiencies to the department that is transferring the goods.
- B. Can lead to suboptimal decisions for the company as a whole.
- C. Must be adjusted by some markup.
- D. Lack clarity and administrative convenience.

**Answer: B**

The optimal transfer price of a selling division should be set at a point that will have the most desirable economic effect on the firm as a whole while at the same time continuing to motivate the management of every division to perform efficiently. Setting the transfer price based on actual costs rather than standard costs would give the selling division little incentive to control costs.

**QUESTION: 217**

A carpet manufacturer maintains a retail division consisting of stores stocking its brand and other brands, and a manufacturing division that makes carpets and pads. An outside market exists for carpet padding material in which all padding produced can be sold. The proper transfer price for padding transferred from the manufacturing division to the retail division is

- A. Variable manufacturing division production cost.
- B. Variable manufacturing division production cost plus allocated fixed factory overhead.
- C. Variable manufacturing division production cost plus variable selling and administrative cost.
- D. The market price at which the retail division could purchase padding.

**Answer: D**

The three basic criteria that the transfer pricing system in a decentralized company should satisfy are to 1) provide information allowing central management to evaluate divisions with respect to total company profit and each division's contribution to profit, 2) stimulate each manager's efficiency without losing each division's autonomy, and 3) motivate each divisional manager to achieve his/her own profit goal in a manner contributing to the company's success. The market price should be used as the transfer price to avoid waste and maximize efficiency in a competitive economy (an outside market in which all padding produced can be sold). This price also measures the product's profitability and the division managers' performance in a competitive environment

**QUESTION: 218**

Division Z of a company produces a component that it currently sells to outside customers for US \$20 per unit. At its current level of production, which is 60% of capacity, Division Z's fixed cost of producing this component is US \$5 per unit and its variable cost is US \$12 per unit. Division Y of the same company would like to purchase this component from Division Z for US \$10. Division Z has enough excess capacity to fill Division Y's requirements. The managers of both divisions are compensated based upon reported profits. Which of the following transfer prices will maximize total company profits and be most equitable to the managers of Division Y and Division Z?

- A. US \$12 per unit.
- B. US \$18 per unit.
- C. US \$20 per unit.
- D. US \$22 per unit.

**Answer: B.**

A unit price of US \$18 is less than Division Y's cost of purchase from an outside supplier but Division Z's production cost. Accordingly, both Y and Z benefit

**QUESTION: 219**

One department of an organization, Final Assembly, is purchasing subcomponents from

another department, Materials Fabrication. The price that will be charged to Final Assembly by Materials Fabrication is to be determined. Outside market prices for the subcomponents are available. Which of the following is the most correct statement regarding a market-based transfer price?

- A. Marginal production cost transfer prices provide incentives to use otherwise idle capacity.
- B. Market transfer prices provide an incentive to use otherwise idle capacity.
- C. Overall long term competitiveness is enhanced with a market-based transfer price.
- D. Corporate politics is more of a factor in a market-based transfer price than with other methods.

**Answer: C**

A transfer price is the price charged in an intercompany transaction. Market-based prices provide market discipline because efficient internal suppliers will tend to prosper, thereby enhancing the overall long-term competitiveness of the firm.

**QUESTION: 220**

Which of the following is not true about international transfer prices for a multinational firm?

- A. Allows firms to attempt to minimize worldwide taxes.
- B. Allows the firm to evaluate each division.
- C. Provides each division with a profit-making orientation.
- D. Allows firms to correctly price products in each country in which it operates.

**Answer: D**

The calculation of transfer prices in the international arena must be systematic. A scheme for calculating transfer prices for a firm may correctly price the firm's product in Country A but not in Country B. The product may be overpriced in Country B, causing sales to be lower than anticipated. Alternatively, the product may be underpriced in Country B, and the authorities may allege that the firm is dumping its product there.

**QUESTION: 221**

Companies with decentralized, autonomous divisions that sell their goods and services internally to other divisions of the company as well as externally in competitive markets have to establish transfer prices for the goods and services transferred internally among divisions. Generally, upper management has established such operating criteria for managing the divisions as goal congruence, subunit autonomy, and a sustained high level of management effort. An approach consistent with the above criteria would be to



set the transfer price equal to the

- A. Additional outlay cost per unit incurred to the point of transfer plus the opportunity cost per unit to the supplying division.
- B. Additional outlay cost per unit incurred to the point of transfer plus the opportunity cost per unit to the buying division.
- C. Full cost per unit incurred to the point of transfer plus a percentage markup on the full cost per unit.
- D. Variable cost per unit incurred to the point of transfer.

**Answer: A**

The outlay costs represent cash outflows related to the production and transfer of goods/services. The opportunity costs are the maximum contribution forgone by the supplying division if the good/services are sold internally. An opportunity cost will exist if the supplier has no idle capacity and an external market exists. Thus, this guideline should promote goal congruence (actions of the divisional manager benefit the company and the division), a sustained high level of managerial effort (exertion toward a goal), and subunit autonomy (freedom in decision making). The guideline will vary depending on whether an external market exists and whether the supplier has idle capacity.

**QUESTION: 222**

A large manufacturing company has several autonomous divisions that sell their products in perfectly competitive external markets as well as internally to the other divisions of the company. Top management expects each of its divisional managers to take actions that will maximize the organization's goals as well as their own goals. Top management also promotes a sustained level of management effort of all of its divisional managers. Under these circumstances, for products exchanged between divisions, the transfer price that will generally lead to optimal decisions for the manufacturing company would be a transfer price equal to the

- A. Full of the product.
- B. Full of the product plus a markup.
- C. Variable cost of the product plus a markup.
- D. Market price of the product.

**Answer: D**

A market price transfer price promotes goal congruence and a sustained level of management effort. It is also consistent with divisional autonomy. A market transfer price is most appropriate when the market is competitive, interdivisional dependency is low, and buying in the market involves no marginal costs or benefits.

**QUESTION: 223**

The Eastern division, it sells goods internally to the Western division of the company. The quoted external price in industry publications from a supplier material near Eastern in US \$ 200 per ton plus transportation. It costs US \$ 20 per ton to transport the goods to Western Eastern's actual market cost per ton to buy the direct materials to make the transferred product is US \$100. Actual per ton direct labor is US \$50. Other actual costs of storage and handling are US \$40. The company president select a US \$220 transfer price. This is an example of

- A. Market-based transfer pricing.
- B. Cost-based transfer pricing.
- C. Negotiated transfer pricing.
- D. Cost-plus-20% transfer pricing.

**Answer: A**

A transfer price is the price charged by one segment of an organization for a product or service supplied to another segment of the same organization. The three basic criteria that the transfer pricing system in a decentralized company should satisfy are to 1) provide information allowing central management to evaluate divisions with respect to total company profit and each division's contribution to profit. 2) stimulate each manager's efficiency without losing each division's autonomy, and 3) motivate each divisional manager to achieve his/her own profit goal in a manner contributing to the company's success. Because the US \$220 transfer price selected is based on the quoted external price (market), it is an example of market-based transfer pricing.

**QUESTION: 224**

Division A of a company is currently operating at 50% capacity. It produces a single product and sells all its production to outside customers for US \$13 per unit. Variable costs are US \$7 per unit, and fixed costs are US \$6 per unit at the current production level. Division B, which currently purchases this product from an outside supplier for US \$12 per unit, would like to purchase the product from Division A. Division A will operate at 80% capacity to meet outside customers' and Division B's demand. What is the minimum price that Division A should charge Division B. for this product?

- A. US \$7.00 per unit.
- B. US \$10.40 per unit.
- C. US \$12.00 per unit.
- D. US \$13.00 per unit.

**Answer: A**

From the seller's perspective, the price should reflect at least its incremental cash outflow (outlay cost) plus the contribution from an outside sale (opportunity cost). Because A has idle capacity, the opportunity cost is 0. Thus, the minimum price Division A should charge Division B is US \$7.00.

**QUESTION: 225**

A domestic company has sales divisions in country X and country Y. The company sells only one product. Which costs US \$20 per unit to produce. There are no trade barriers or tariffs among the three countries. Information specific to each of the three countries is as follows:

Country	Corporate Tax Rate	Before-Tax Selling Price	Quantity Sold	Additional Costs
Home	50%	US \$30	1,500	US \$10,000
X	60%	US \$40	1,000	US \$12,500
Y	40%	US \$35	2,000	US \$11,000

When selling items to its sales divisions in <List A>, the Company should set the <List B> allowable transfer price.

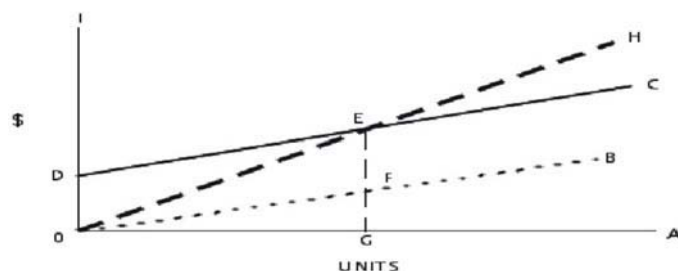
	List A	List B
A.	Countries X and Y	Highest
B.	Countries X and Y	Lowest
C.	Country X	Highest
D.	Country Y	Highest

**Answer: C**

Country X has a higher tax rate than the home country, so the incentive is to transfer profits out of country X. The sales division in country X will be less profitable if it is charged a high transfer price, hence pay less tax.

**QUESTION: 226**

Presented below is a cost-volume-profit chart for a firm. Various reference points are marked on the chart with letters



The letters CEH on the chart represent the

- A. Total sales.
- B. total expenses.
- C. Area of the chart where total sales exceed total expenses
- D. Area of the chart where total expenses exceed total sales

**Answer: C**

A cost-volume-profit chart contains elements (lines, points, axes) that identify variable cost, fixed cost, the breakeven point, total revenue, profit, and volume in units. When the total sales revenue line rises above the total expense line, a company will have positive net income.

**QUESTION: 227**

A company manufactures a single product. Estimated cost data regarding this product and other information for the product and the company are as follows:

Sales price per unit	US \$40
Total variable production cost per unit	US \$22
Sales commission (on sales)	5%
Fixed costs and expenses:	
Manufacturing overhead	US \$5,598,720
General and administrative	US \$3,732,480
Effective income tax rate	40%

The number of units the company must sell in the coming year in order to reach its breakeven point is

- A. 388,800 units.
- B. 518,400 units.
- C. 583,200 units.
- D. 972,000 units.

**Answer: C**

The breakeven point is determined by dividing total fixed costs by the unit contribution margin. The total fixed costs are US \$9,331,200 (\$5,598,720 manufacturing overhead + \$3,732,480 general and administrative). The contribution margin is US \$16.00 (\$40 sales price - \$22 variable production cost - \$2 commission). Thus, the breakeven point is 583,200 units (US \$9,331,200 ÷ \$16).

**QUESTION: 228**

A retail company determines its selling price by marking up variable costs 60%. In addition, the company uses frequent selling price markdowns to stimulate sales. If the markdowns average 10%, what is the company's contribution margin ratio?

- A. 27.5%
- B. 30.6%
- C. 37.5%
- D. 41.7%

**Answer: B.**

The contribution margin equals revenues minus variable costs. The CMR equals the UCM divided by the selling price. For example, if variable costs average US \$10 per unit, the average selling price is US \$16 (\$10 x 1.60). However, the 10% markdown implies that the actual average selling price is US \$14.40 (1.10 x \$16). The CMR is therefore 30.6% [US \$14.40 - \$10.00) / \$14.40]. A company that sells its single product for US \$40 per unit uses cost-volume-profit analysis in its planning. The company's after-tax profit for the past year was US \$1,188,000 applying an effective tax rate of 40%. The projected costs for manufacturing and selling its single product in the coming year are listed.

Variable costs per unit:	
Direct materials	US \$ 5.00
Direct labor	4.00
Manufacturing overhead	6.00
Selling and administrative costs	3.00
Total cost per unit	<u>US \$18.00</u>
Annual fixed operating costs:	
Manufacturing overhead	US \$6,200,000
Selling and administrative costs	3,700,000
Total annual fixed cost	<u>US \$9,900,000</u>

**QUESTION: 229**

The dollar sales volume required in the coming year to earn the same after-tax profit as the past year is

- A. US \$20,160,000
- B. US \$21,600,000
- C. US \$23,400,000
- D. US \$26,400,000

**Answer: B.**

The desired after-tax profit is US \$1,188,000 (the past year's amount). Given a 40% tax rate, the pretax equivalent is US \$1,980,000 [US \$1,188,000 / (1 - 0.40)]. Pretax profit equals dollar sales (unit sales x US \$40), minus total fixed costs, minus total variable costs (unit

sales x unit variable cost). Hence, the contribution margin (sales - variable costs) is equated with the sum of fixed costs and the targeted pretax profit. Unit sales (S) equal 540,000, and sales dollars equal US \$21,600,000 (540,000 units x \$40).

$$\begin{aligned} \text{US } \$40S - \$9,900,000 - \$18S &= \text{US } \$1,980,000 \\ \text{US } \$22S &= \text{US } \$11,880,000 \\ S &= 540,000 \text{ units} \end{aligned}$$

A company that sells its single product for US \$40 per unit uses cost-volume-profit analysis in its planning. The company's after-tax profit for the past year was US \$1,188,000 applying an effective tax rate of 40%. The projected costs for manufacturing and selling its single product in the coming year are listed.

Variable costs per unit:	
Direct materials	US \$ 5.00
Direct labor	4.00
Manufacturing overhead	6.00
Selling and administrative costs	3.00
Total cost per unit	<u>US \$18.00</u>
Annual fixed operating costs:	
Manufacturing overhead	US \$6,200,000
Selling and administrative costs	3,700,000
Total annual fixed cost	<u>US \$9,900,000</u>

**QUESTION: 230**

The company has learned that a new direct material is available that will increase the quality of its product. The new material will increase the direct materials costs by US \$3 per unit. The company will increase the selling price of the product to US \$50 per unit and increase its marketing costs by US \$1,575,000 to advertise the higher-quality product. The number of units the company has to sell to earn a 10% before-tax return on sales is

- A. 337,500 units.
- B. 346,875 units.
- C. 425,000 units.
- D. 478,125 units.

**Answer: D**

Pretax profit (10% of dollar sales) equals dollar sales (unit sales US \$50), minus total fixed costs (increased by US \$1,575,000 of marketing costs), minus total variable costs (increased by US \$3 per unit). Unit sales (S) therefore equal 478,125 units.

$$\begin{aligned} .10(\text{US } \$50S) &= \text{US } \$50S - \$9,900,000 - \$1,575,000 - (\$18 + \$3)S \\ \text{US } \$5S &= \$29S - 11,475,000 \\ \text{US } \$24S &= 11,475,000 \\ S &= 478,125 \text{ units} \end{aligned}$$

**QUESTION: 231**

A company has sales of US \$500,000, variable costs of US \$300,000 and pretax profit of US \$150,000. If the company increased the sales price per unit by 10%, reduced fixed costs by 20%, and left variable cost per unit unchanged, what would be the new breakeven point in sales dollars?

- A. US \$88,000
- B. US \$100,000
- C. US \$110,000
- D. US \$125,000

**Answer: A**

The breakeven point in sales dollars is equal to the sum of fixed cost plus any desired pretax profit, divided by contribution margin ratio [sales - variable costs] - sales]. Fixed cost was US \$50,000 (\$500,000 sales - \$300,000 VC - \$150,000 pretax profit). Given the increase in sales of 10% and decrease in fixed costs of 20%, the breakeven point in sales is US \$88,000.

$$\frac{\text{Fixed costs (US \$50,000} \times .8) + \text{Desired pretax profit 0}}{\text{Sales [(US \$500,000} \times 1.1) - \text{Variable costs \$300,000]} + \text{Sales (US \$500,000} \times 1.1)} = \frac{\text{US \$40,000}}{\text{US \$250,000} + \text{US \$550,000}}$$

A company manufactures and sells a single product. It takes two machine hours to produce one unit. Annual sales are expected to be 75,000 units. Annual production capacity is 200,000 machine hours. Expected selling price is US \$10 per unit. Cost data for manufacturing and selling the product are as follows:

Variable costs (per unit)	
Direct materials	US \$3.00
Direct labor	1.00
Variable manufacturing overhead	0.80
Variable selling	2.00
Fixed costs (per year)	
Fixed manufacturing overhead	US \$90,000
Fixed selling	60,000

**QUESTION: 232**

The company receives a special order for 10,000 units at US \$7.60. Variable selling cost for each of these 10,000 units will be US \$1.20. This special order will not affect regular sales of 75,000 units. If the company accepts this special order, its profit will

- A. Increase by US \$8,000.
- B. Increase by US \$16,000.

- C. Decrease by US \$4,000.  
D. Decrease by US \$12,000.

**Answer:** B.

If the company accepts the special order, its revenue will increase by US \$76,000 (10,000 units x \$7.60). However, its incremental cost will include only the variable costs because fixed manufacturing and selling costs will be unchanged. The increase in cost from accepting the special order is US \$60,000 [10,000 units x (\$3.00 + \$1.00 + \$0.80 + \$1.20)]. Thus, acceptance of the special order will increase profits by US \$16,000 (\$76,000 - \$60,000). A company manufactures and sells a single product. It takes two machine hours to produce unit. Annual sales are expected to be 75,000 units. Annual production capacity is 200,000 machine hours. Expected selling price is US \$10 per unit. Cost data for manufacturing and selling the product are as follows:

Variable costs (per unit)	
Direct materials	US \$3.00
Direct labor	1.00
Variable manufacturing overhead	0.80
Variable selling	2.00
Fixed costs (per year)	
Fixed manufacturing overhead	US \$90,000
Fixed selling	60,000

**QUESTION:** 233

The company estimates that by reducing its selling price to US \$9.30 per unit, it can increase sales to 90,000 units annually. Fixed costs per year and unit variable costs will remain unchanged. If the company reduces its selling price to US \$9.30 per unit, its profit will

- A. Decrease by US \$5,000.  
B. Decrease by US \$15,000.  
C. Decrease by US \$45,000.  
D. Increase by US \$15,000.

**Answer:** B.

Since total fixed costs are unaffected, the change in profit is the change in the contribution margin. The contribution margin at the current selling price is US \$240,000 [75,000 units x (\$10 - \$3 - \$1 - \$0.80 - \$2)]. The contribution margin at the US \$9.30 selling price is US \$225,000 [90,000 units x (\$9.30 - \$3 - \$1 - \$0.80 - \$2)]. Hence, profit will be reduced by US \$15,000 (\$240,000 - \$225,000) if the selling price is lowered to US \$9.30.

**QUESTION:** 234



A company has US \$450,000 per year of fixed production costs, of which US \$150,000 are noncash outlays. The variable cost per unit is US \$15, and the unit selling price is US \$25. The breakeven volume in sales units for this company would be

- A. 18,000 units.
- B. 30,000 units.
- C. 45,000 units.
- D. 60,000 units.

**Answer: C**

The breakeven volume in sales units equals fixed costs divided by the unit contribution margin unit price - unit variable cost). Hence, the breakeven point is 45,000 units [US \$450,000 - \$25 - \$15)]. Data regarding Year 1 operations for an enterprise that had no beginning or ending inventories are as follows:

Sales (150,000 units)	US \$9,000,000
Variable costs:	
Direct materials	US \$1,800,000
Direct labor	720,000
Manufacturing overhead	1,080,000
Selling expenses	450,000
Fixed costs:	
Manufacturing overhead	US \$ 600,000
Administrative expenses	567,840
Selling expenses	352,800
Income tax rate	40%

The enterprise estimates that next year direct materials costs will increase by 10% and direct labor costs will increase by US \$0.60 per unit to US \$5.40 per unit. In addition, fixed selling expenses will increase by US \$29,520. All other costs will be incurred at the same rates or amounts as the current year.

**QUESTION: 235**

The total contribution margin for Year 1 is

- A. US \$2,970,000
- B. US \$4,950,000
- C. US \$5,400,000
- D. US \$6,030,000

**Answer: B.**

The total contribution margin equals sales minus variable costs, or US \$4,950,000 (\$9,000,000 - \$1,800,000 - \$720,000 - \$1,080,000 - \$450,000). Data regarding Year 1 operations for an enterprise that had no beginning or ending inventories are as follows:

Sales (150,000 units)	US \$9,000,000
Variable costs:	
Direct materials	US \$1,800,000
Direct labor	720,000
Manufacturing overhead	1,080,000
Selling expenses	450,000
Fixed costs:	
Manufacturing overhead	US \$ 600,000
Administrative expenses	567,840
Selling expenses	352,800
Income tax rate	40%

The enterprise estimates that next year direct materials costs will increase by 101 and direct labor costs will increase by US \$0.60 per unit to US \$5.40 per unit. In addition, fixed selling expenses will increase by US \$29,520. All other costs will be incurred at the same rates or amounts as the current year.

**QUESTION: 236**

The gross margin for Year 1 is

- A. US \$3,429,360
- B. US \$4,232,160
- C. US \$4,350,000
- D. US \$4,800,000

**Answer: D**

The gross margin equals revenue minus cost of goods sold (beginning finished goods inventory + cost of goods manufactured - ending finished goods inventory). Cost of goods manufactured equals all manufacturing adjusted for the change in work-in-progress. Consequently, the gross margin was US \$4,800,000 (\$9,000,000 - \$1,800,000 DM - \$720,000 DL - \$1,080,000 VMOH - \$600,000 FMOH), given no beginning or ending finished goods or work-in-process inventories. Data regarding Year 1 operations for an enterprise that had no beginning or ending inventories are as follows:

Sales (150,000 units)	US \$9,000,000
Variable costs:	
Direct materials	US \$1,800,000
Direct labor	720,000
Manufacturing overhead	1,080,000
Selling expenses	450,000
Fixed costs:	
Manufacturing overhead	US \$ 600,000
Administrative expenses	567,840
Selling expenses	352,800
Income tax rate	40%

The enterprise estimates that next year direct materials costs will increase by 101 and direct labor costs will increase by US \$0.60 unit to US \$5.40 per unit. In addition, fixed

selling expenses will increase by US \$29,520. All other costs will be increased at the same rates or amounts as the, current year.

**QUESTION: 237**

The breakeven point in unit sales for Year 1 is

- A. 36,495 units.
- B. 42,240 units.
- C. 46,080 units.
- D. 56,320 units.

**Answer: C**

The breakeven point in unit sales equals total fixed costs divided by the unit contribution margin (UCM). Total fixed costs are US \$1,520,640 (\$600,000 + \$720,000 + \$352,800), and the UCM is US \$33 [(\$4,950,000 contribution margin sales minus variable costs) - 100,000 units sold]. Hence, the breakeven point in unit sales is 46,080 units (US \$1,520,640 ÷ \$33). Data regarding Year 1 operations for an enterprise that had no beginning or ending inventories are as follows.

Sales (150,000 units)	US \$9,000,000
Variable costs:	
Direct materials	US \$1,800,000
Direct labor	720,000
Manufacturing overhead	1,080,000
Selling expenses	450,000
Fixed costs:	
Manufacturing overhead	US \$ 600,000
Administrative expenses	567,840
Selling expenses	352,800
Income tax rate	40%

The enterprise estimates that next year direct materials costs will increase by 10% and direct labor costs will increase by 10%. To U. unit to US \$5.40 per unit. In addition, fixed selling expenses will increase by US \$29,520. All other costs will be incurred at the same rates or amounts as the current year.

**QUESTION: 238**

What dollar sales volume, to the nearest dollar, would be required in Year 2 to earn the same net income as in Year 1?

- A. US \$6,938,031
- B. US \$8,736,000
- C. US \$9,576,000
- D. US \$10,374,000

**Answer: C**

To earn the same net income in Year 2 as in Year 1, the contribution margin must equal the sum of the Year 1 pretax operating income and the Year 2 fixed costs. The pretax operating income is calculated as US \$3,429,360 (\$9,000,000 - \$4,050,000 variable costs - \$1,520,640 fixed costs). Fixed costs in Year 2 will be the same as in Year 1 except for an increase of \$29,520 in fixed selling expenses, a total of US \$1,550,160 (\$1,520,640 as previously calculated + \$29,520). The desired Year 2 sales volume must equal the Year 2 contribution margin of US \$4,979,520 (\$3,429,360 desired pretax operating income + \$1,550,160 fixed costs in Year 2) divided by the contribution margin ratio (CMR). The CMR may be determined from the unit price constant at US \$9,000,000 ÷ 150,000 units = US \$60 per unit) and unit variable cost data. Unit direct materials cost in Year 2 will increase by 10% to US \$13.20 [\$1.1 × \$1,800,000 ÷ 150,000 units). Unit direct labor cost in Year 2 is given as US \$5.40. Unit variable overhead cost is constant at US \$7.20 (\$1,080,000 ÷ 150,000 units). Unit variable selling expense is constant at US \$3.00 (\$450,000 ÷ 150,000 units). Thus, total unit variable cost is US \$28.80 (\$13.20 + \$5.40 + \$7.20 + \$3.00), and the UCM is US \$31.20 (\$60 unit selling price - \$28.80). The CMR is therefore US \$31.20 ÷ \$60.00 = 52%, and the desired Year 2 sales volume is US \$4,979,520 ÷ 52% = \$9,576,154.

Data regarding Year 1 operations for an enterprise that had no beginning or ending

Sales (150,000 units)	US \$9,000,000
Variable costs:	
Direct materials	US \$1,800,000
Direct labor	720,000
Manufacturing overhead	1,080,000
Selling expenses	450,000
Fixed costs:	
Manufacturing overhead	US \$ 600,000
Administrative expenses	567,840
Selling expenses	352,800
Income tax rate	40%

The enterprise estimates that next year direct materials costs will increase by 10% and direct labor costs will increase by US \$0.60 per unit to US \$5.40 per unit. In addition, fixed selling expenses will increase by US \$29,520. All other costs will be incurred at the same rates or amounts as the current year.

**QUESTION: 239**

What selling price would the company have to charge for its product in Year 2 to maintain the same contribution margin percentage rate as in Year 1?

- A. US \$61.80
- B. US \$64.00
- C. US \$64.50
- D. US \$72.00

**Answer:** B.

The CMR equals unit contribution margin (UCM) divided by unit selling price. The UCM equals the unit selling price minus unit variable cost. The original unit selling price was US \$60 (\$9,000,000 revenue / 150,000 units), and the original unit variable cost was US \$27 [(\$1,800,000 + \$720,000 + \$1,080,000 + \$450,000) / 150,000 units]. The original CPr1R was therefore US \$.55 [(\$60 - \$27) / \$60]. The new unit variable cost was calculated as US \$28.80. Accordingly the unit selling price (X) is US \$64.

$$\begin{aligned}
 (X - \text{US } \$28.80) / X &= \text{US } \$.55 \\
 X - \text{US } \$28.80 &= \text{US } \$.55X \\
 \text{US } \$.45X &= \text{US } \$28.80 \\
 X &= \text{US } \$28.8 / .45 \\
 X &= \text{US } \$64
 \end{aligned}$$

**QUESTION:**240

The following data apply to one item sold by a large retailer: Purchase price US \$ 4.95

Purchase price	US \$4.95
Variable selling expenses	US \$2.00
Variable administrative expenses	US \$1.00
Fixed costs	US \$7,500
Expected annual sales	5,000 units

Using the contribution approach to pricing, which of the following prices is the lowest that can be charged in the short run?

- A. US \$5.00
- B. US \$7.00
- C. US \$8.00
- D. US \$9.50

**Answer:** C

In the short run, the fixed costs are sunk costs. They will be incurred whether or not the item is produced. Accordingly the retailer will suffer no additional loss if the price charged covers the incremental costs, which are the variable costs in this case. The lowest feasible price is the one that provides a zero (but not a negative) contribution margin (revenue - variable costs). Thus, the lowest short-run price is the unit variable cost (US \$4.95 + \$2.00 + \$1.00 = US\$7.95). The lowest price provided in the answer choices that will recover the unit variable cost is US \$8.00.

**QUESTION:** 241

If the government were to increase corporate tax rates, after-tax cost-volume-profit relationships for individual firms would change as follows

- A. Breakeven points would increase.

- B. Breakeven points would decrease.
- C. There would be no change in the breakeven points.
- D. There would be no change whatsoever in cost-volume-profit relationships.

**Answer: C**

The firm owes no tax if it does not earn a profit. At the breakeven point, there is no profit. Thus, a tax increase would have no effect on a firm's breakeven point, which is calculated by dividing fixed costs by the contribution margin ratio. The contribution margin equals sales revenues minus total variable costs. A business needs a computer application that can be either developed internally or purchased. Computer time is charged using developed internally or purchased. Suitable software from a predetermined rates. The organization has sufficient excess vendor costs US \$29,000. Minor modifications and testing can be conducted by the systems staff as part of their regular workload. If the software is developed internally, a systems analyst would be assigned full time, and a contractor would assume the analyst's responsibilities. The hourly rate for the regular analyst is US \$25. The hourly rate for the contractor is US \$22. The contractor would occupy an empty office. The office has 100 square feet, and occupancy cost is US \$45 per square foot. Computer capacity for either software development or modification/testing of the purchased software.

	<u>Internal Development</u>	<u>Purchased Software</u>
Systems analyst time in hours:		
Development	1,000	N/A
Modifications and testing	N/A	40
Computer charges	US \$800	US \$250
Additional hardware purchases	US \$3,200	N/A
Incidental supplies	US \$500	US \$200

**QUESTION: 242**

When applying the cost-benefit approach to a decision, the primary criterion is how well management goals will be achieved in relation to costs. Costs include all expected.

- A. Variable costs for the courses of action but not expected fixed costs because only the expected variable costs are relevant.
- B. Incremental out-of-pocket costs as well as all expected continuing costs that are common to all the alternative courses of action.
- C. Future costs that differ among the alternative courses of action plus all qualitative factors that cannot be measured in numerical terms.
- D. Historical and future costs relative to the courses of action including all qualitative factors that cannot be measured in numerical terms.

**Answer: C**

The analysis of a make-or-buy decision is based on relevant costs. If costs do not vary with the option chosen, they are irrelevant. Moreover, the decision may be based on

nonquantitative factors, for example, the desire to maintain a relationship with a vendor or to assume control over development of a product. A business needs a computer application that can be either developed internally or purchased. Computer time is charged using developed internally or purchased. Suitable software from a predetermined rates. The organization has sufficient excess vendor costs US \$29,000. Minor modifications and testing can be conducted by the systems staff as part of their regular workload. If the software is developed internally, a systems analyst would be assigned full time, and a contractor would assume the analyst's responsibilities. The hourly rate for the regular analyst is US \$25. The hourly rate for the contractor is US \$22. The contractor would occupy an empty office. The office has 100 square feet, and occupancy cost is US \$45 per square foot. Computer capacity for either software development or modification/testing of the purchased software.

	<u>Internal Development</u>	<u>Purchased Software</u>
Systems analyst time in hours:		
Development	1,000	N/A
Modifications and testing	N/A	40
Computer charges	US \$800	US \$250
Additional hardware purchases	US \$3,200	N/A
Incidental supplies	US \$500	US \$200

**QUESTION: 243**

Based solely on the cost figures presented, the cost of developing the computer application will be

- A. Less than acquiring the purchased software package by US \$3,500.
- B. Less than acquiring the purchased software package by US \$500.
- C. More than acquiring the purchased software package by US \$1,550.
- D. More than acquiring the purchased software package by US \$3,550.

**Answer: A**

Development cost equals the cost of the outside contractor plus the costs for hardware and supplies. Computer charges are transfer prices and do not require additional expenditures, given idle capacity. The relevant cost of supplies is US \$300 (\$500 - \$200 cost if the software are purchased). The contractor's use of an otherwise idle office is not relevant. Thus, the relevant cost of development is US \$25,500 [(1,000 hours x \$22 hourly cost of the contractor) + \$3,200 hardware purchases + \$300 incremental cost of supplies]. This amount is US \$3,500 less than the US \$29,000 cost of purchase. A systems analyst's work on the new software is not relevant. It is part of the regular workload.

**QUESTION: 244**

A manufacturing company's primary goals include product quality and customer satisfaction. The company sells a product, for which the market demand is strong, for US

\$50 per unit. Due to the capacity constraints in the Production Department, only 300,000 units can be produced per year. The current defect rate is 12% i.e., of the 300,000 units produced, only 264,000 units are sold and 36,000 units are scrapped). There is no revenue recovery when defective units are scrapped. The full manufacturing cost of a unit is US \$29.50, including

Direct materials	US \$17.50
Direct labor	4.00
Fixed manufacturing overhead	8.00

The company's designers have estimated that the defect rate can be reduced to 2% by using a different direct material. However, this will increase the direct materials cost by US \$2.50 per unit to US \$20 per unit. The net benefit of using the new material to manufacture the product will be

- A. US \$ 120,000)
- B. US \$120,000
- C. US \$750,000
- D. US \$1,425,000

**Answer: C**

If a different direct material is used, incremental revenue will be US \$1,500,000  $\{ [12\% \text{ defect rate} - 2\%] \times 300,000 \text{ units} \} \times \text{Incremental cost}$  will be US \$750,000  $\{ \$2.50 \times 300,000 \text{ units} \}$ . Thus, the net benefit will be US \$750,000  $\{ \$1,500,000 - \$750,000 \}$ .

**QUESTION: 245**

The ABC Company manufactures components for use in producing one of its finished products. When 12,000 units are produced, the full cost per unit is US \$35, separated as follows:

Direct materials	US \$ 5
Direct labor	15
Variable overhead	10
Fixed overhead	5

The XYZ Company has offered to sell 12,000 components to ABC for US \$37 each. If ABC accepts the offer, some of the facilities currently being used to manufacture the components can be rented as warehouse space for US \$40,000. However, US \$3 of the fixed overhead currently applied to each component would have to be covered by ABC's other products. What is the differential cost to the ABC Company of purchasing the components from the XYZ Company?

- A. US \$8,000
- B. US \$20,000



- C. US \$24,000  
D. US \$44,000

**Answer: B.**

Differential (incremental) cost is the difference in total cost between two decisions. The relevant costs do not include unavoidable costs, such as the US \$3 of fixed overhead. It would cost ABC an additional US \$20,000 to purchase, rather than manufacture, the components.

Cost to purchase (12,000 × US \$37)	US \$444,000
Minus rental income	<u>(40,000)</u>
	\$404,000
Cost to manufacture (12,000 × US \$32)	<u>384,000</u>
Cost differential	<u><u>US \$ 20,000</u></u>

The segmented income statement for a retail company with three product lines is presented below:

	<u>Total Company</u>	<u>Product Line 1</u>	<u>Product Line 2</u>	<u>Product Line 3</u>
Volume (in units)		20,000	28,000	50,000
Sales revenue	US \$2,000,000	US \$800,000	US \$700,000	US \$500,000
Costs & expenses:				
Administrative	US \$ 180,000	US \$ 60,000	US \$ 60,000	US \$ 60,000
Advertising	240,000	96,000	84,000	60,000
Commissions	40,000	16,000	14,000	10,000
Cost of sales	980,000	360,000	420,000	200,000
Rent	280,000	84,000	140,000	56,000
Salaries	<u>110,000</u>	<u>54,000</u>	<u>32,000</u>	<u>24,000</u>
Total costs & expenses	<u>US \$1,830,000</u>	<u>US \$670,000</u>	<u>US \$750,000</u>	<u>US \$410,000</u>
Operating income (loss)	<u><u>US \$ 170,000</u></u>	<u><u>US \$130,000</u></u>	<u><u>US \$ (50,000)</u></u>	<u><u>US \$ 90,000</u></u>

The company buys the goods in the three product lines directly from manufacturers' representatives. Each product line is directed by a manager whose salary is included in the administrative expenses. Administrative expenses are allocated to the three product lines equally because the administration is spread evenly among the three product lines. Salaries represent payments to the workers in each product line and therefore are traceable costs of each product line. Advertising promotes the entire company rather than the individual product lines. As a result, the advertising is allocated to the three product lines in proportion to the sales revenue. Commissions are paid to the salespersons in each product line based on 2% of gross sales. Rent represents the cost of the retail store and warehouse under a lease agreement with 5 years remaining. The product lines share the retail and warehouse space, and the rent is allocated to the three product lines based on the square footage occupied by each of the product lines.

**QUESTION: 246**

The 88mpany has an opportunity to promote one of its product lines by making a one-

time US \$7,000 expenditure. The company can choose only one of the three product lines to promote. The incremental sales revenue that would be realized from this US \$7,000 promotion expenditure in each of the product lines is estimated as follows:

	<u>Increase in Sales Revenue</u>
Product Line 1	US \$15,000
Product Line 2	20,000
Product Line 3	14,000

In order to maximize profits, the promotion expenditure should be spent on <List A>, resulting in an increase in operating income of <List B>.

	<u>List A</u>	<u>List B</u>
A.	Product Line 2	US \$13,000
B.	Product Line 2	US \$ 5,000
C.	Product Line 3	US \$ 1,400
D.	Product Line 3	US \$ 1,120

**Answer: D**

Fixed costs should be ignored. Thus, the increase in sales revenue should be multiplied by the contribution margin ratio for each product line. The incremental promotion cost (US \$7,000) is subtracted from this amount to determine the marginal benefit of promoting each product line. Hence, Product Line 3 has an increased profit of US\$1,120.

	<u>Calculation of Contribution Margin</u>			
	<u>Total Company</u>	<u>Product Line 1</u>	<u>Product Line 2</u>	<u>Product Line 3</u>
Sales revenue	US \$2,000,000	US \$800,000	US \$700,000	US \$500,000
Variable costs				
Commissions	\$ 40,000	\$ 16,000	\$ 14,000	\$ 10,000
Cost of sales	980,000	360,000	420,000	200,000
Total	\$1,020,000	\$376,000	\$434,000	\$210,000
CM	\$ 980,000	\$424,000	\$266,000	\$290,000
CMR	49%	53%	38%	58%
Revenue		\$ 15,000	\$ 20,000	\$ 14,000
CMR		.53	.38	.58
CM		\$ 7,950	\$ 7,600	\$ 8,120
Promotion cost		7,000	7,000	7,000
Increased profits		US \$ 950	US \$ 600	US \$ 1,120

The company buys the goods in the three product lines directly from manufacturers' representatives. Each product line is directed by a manager whose salary is included in the administrative expenses. Administrative expenses are allocated to the three product

lines equally because the administration is spread evenly among the three product lines. Salaries represent payments to the workers in each product line and therefore are traceable costs of each product line. Advertising promotes the entire company rather than the individual product lines. As a result, the advertising is allocated to the three product lines in proportion to the sales revenue. Commissions are paid to the salespersons in each product line based on 2% of gross sales. Rent represents the cost of the retail store and warehouse under a lease agreement with 5 years remaining. The product lines share the retail and warehouse space, and the rent is allocated to the three product lines based on the square footage occupied by each of the product lines.

**QUESTION: 247**

One company executive has expressed concern about the operating loss that has occurred in Product Line 2 and has suggested that Product Line 2 be discontinued. If Product Line 2 is dropped, the manager of the line would be retained and assigned other duties with the company, but the other employees would not be retained. Management has indicated that the nature of the company's advertising might change with the elimination of Product Line 2, but the total dollar amount would not change. If Product Line 2 were to be dropped, the operating income of the company would

- A. Increase by US \$50,000
- B. Decrease by US \$94,00
- C. Decrease by US \$234,0
- D. In crease by US \$416,000.

**Answer: C**

The operating income will decrease. Product Line 2 income will be lost, but only the traceable costs of commissions, cost of sales, and salaries will be avoided. Accordingly, the decrease will be US \$234,000 [ $-\$700,000 + \$14,000 + \$420,000 + \$32,000$ ]. The other shared costs will have to be absorbed by the two remaining product lines.

The segmented income statement for a retail company with three product lines is presented below

	<u>Total Company</u>	<u>Product Line 1</u>	<u>Product Line 2</u>	<u>Product Line 3</u>
Volume (in units)		20,000	28,000	50,000
Sales revenue	US \$2,000,000	US \$800,000	US \$700,000	US \$500,000
Costs & expenses:				
Administrative	US \$ 180,000	US \$ 60,000	US \$ 60,000	US \$ 60,000
Advertising	240,000	96,000	84,000	60,000
Commissions	40,000	16,000	14,000	10,000
Cost of sales	980,000	360,000	420,000	200,000
Rent	280,000	84,000	140,000	56,000
Salaries	110,000	54,000	32,000	24,000
Total costs & expenses	<u>US \$1,830,000</u>	<u>US \$670,000</u>	<u>US \$750,000</u>	<u>US \$410,000</u>
Operating income (loss)	<u>US \$ 170,000</u>	<u>US \$130,000</u>	<u>US \$ (50,000)</u>	<u>US \$ 90,000</u>

The company buys the goods in the three product lines directly from manufacturers' representatives. Each product line is directed by a manager whose salary is included in the administrative expenses. Administrative expenses are allocated to the three product lines equally because the administration is spread evenly among the three product lines. Salaries represent payments to the workers in each product line and therefore are traceable costs of each product line. Advertising promotes the entire company rather than the individual product lines. As a result, the advertising is allocated to the three product lines in proportion to the sales revenue. Commissions are paid to the salespersons in each product line based on 2% of gross sales. Rent represents the cost of the retail store and warehouse under a lease agreement with 5 years remaining. The product lines share the retail and warehouse space, and the rent is allocated to the three product lines based on the square footage occupied by each of the product lines.

**QUESTION: 248**

A customer, operating in isolated foreign market, has approached the head salesperson for Product Line I and offered to purchase 4,000 units of a special-order product over the next 12 months. This product would be sold in the same manner as Product Line 1's other products except that the customer is hoping for a price break. Product Line 1's cost to purchase this product (cost of sales) would be US \$14.70. Product Line 1 has excess capacity, meaning that the rate or amount of the remaining operating costs would not change as a consequence of the purchase and sale of this special-order product. The minimum selling price for this special-order product would be

- A. US \$15.00
- B. US \$17.30
- C. US \$27.50
- D. US \$30.20

**Answer: A**

Product Line I needs to cover its variable out-of-pocket costs as a minimum on this special-order product: therefore, any selling price greater than the variable cost will contribute towards profits. Thus, the minimum selling price of the special-order product is the variable cost divided by 1 minus the commission rate, or  $US\$14.70 \div 1.0 - 0.2$ ].

**QUESTION: 249**

A company manufactures a product that is sold for US \$37.95. It uses an absorption-cost system. Plant capacity is 750,000 units annually, but normal volume is 500,000 units. Costs at normal volume are given below.

	<u>Unit Cost</u>	<u>Total Cost</u>
Direct materials	US \$ 9.80	US \$ 4,900,000
Direct labor	4.50	2,250,000
Manufacturing overhead	12.00	6,000,000
Selling and administrative:		
Variable	2.50	1,250,000
Fixed	4.20	2,100,000
Total cost	<u>US \$33.00</u>	<u>US \$16,500,000</u>

Fixed manufacturing overhead is budgeted at US \$4.5 million. A customer has offered to purchase 100,000 units at US \$25.00 each to be packaged in large cartons, not the normal individual containers. It will pick up the units in its own trucks. Thus, variable selling and administrative expenses will decrease by 60%. The company should compare the total revenue to be derived from this order with the total relevant costs of

- A. U S \$1,830,000
- B. U S \$1,880,000
- C. U S \$2,930,000
- D. U S \$3,150,000

**Answer: A**

The necessary assumptions are that all fixed costs and the unit variable costs of direct materials, direct labor, and variable manufacturing overhead are not affected by the special order. Hence, the fixed costs are not relevant. The unit costs of direct materials and direct labor are given as US \$9.80 and US \$4.50, respectively. The unit variable manufacturing overhead cost is US \$3.00 [ \$6,000,000 total manufacturing overhead - \$4,500,000 total fixed manufacturing overhead) 500,000 units normal volume]. The unit variable selling and administrative cost is US \$1.00 [\$2.50 x 1.0 - .6)]. Consequently, the total relevant cost of the special order is US \$1,830,000 [100,000 units x \$9.80 + \$4.50 + \$3.00 + \$1.00)]. A manufacturing company is considering a new product for the coming year, which is an electric motor the company can purchase from a reliable vendor for US \$21.00 per unit. The alternative is to manufacture the motor internally. The company has excess capacity to manufacture the 30,000 motors needed in the coming year except for manufacturing space and special machinery. The machinery can be leased for US \$45,000 annually. Finished goods warehouse space adjoining the main manufacturing facility, leased for US \$39,000 annually, can be converted and used to manufacture the motors. Additional off-site space can be leased at an annual cost of US \$54,000 to replace the finished goods warehouse. The estimated unit costs for manufacturing the motors internally, exclusive of the leasing costs itemized above, are

Direct material	US \$ 8.00
Direct labor	4.00
Variable manufacturing overhead	3.00
Allocated fixed manufacturing overhead	5.00
Total manufacturing cost per unit	<u>US \$20.00</u>

**QUESTION: 250**

A cost-benefit analysis would show that the manufacturing company would save

- A. US \$54,000 by purchasing the motors from the outside vendor.
- B. US \$69,000 by purchasing the motors from the outside vendor.
- C. US \$81,000 by making the motors internally.
- D. US \$96,000 by making the motors internally.

**Answer: C**

The relevant costs of making the motor are direct materials, direct labor, variable manufacturing overhead, rental costs of the special machinery, and rental costs of the new warehouse. The fixed manufacturing overhead and the costs of the current warehouse space are not relevant because they will be incurred regardless of whether the motor is made or bought. Buying the motor will cost US \$630,000 (30,000 x \$21). Making the motor will cost US \$549,000 {[30,000 x \$8 DM + \$4 DL + \$3 VOH] + \$54,000 + \$45,000}. Hence, making the motor saves US \$81,000 (\$630,000 - \$549,000). A manufacturing company is considering a new product for the coming year, which is an electric motor the company can purchase from a reliable vendor for US \$21.00 per unit. The alternative is to manufacture the motor internally. The company has excess capacity to manufacture the 30,000 motors needed in the coming year except for manufacturing space and special machinery. The machinery can be leased for US \$45,000 annually. Finished goods warehouse space adjoining the main manufacturing facility, leased for US \$39,000 annually, can be converted and used to manufacture the motors. Additional off-site space can be leased at an annual cost of US \$54,000 to replace the finished goods warehouse. The estimated unit costs for manufacturing the motors internally, exclusive the leasing costs itemized above, are

Direct material	US \$ 8.00
Direct labor	4.00
Variable manufacturing overhead	3.00
Allocated fixed manufacturing overhead	5.00
Total manufacturing cost per unit	<u>US \$20.00</u>

**QUESTION: 251**

If the manufacturing company decides to use its excess manufacturing capacity for the motors, the contribution or net benefit that could have been obtained from other alternative uses is referred to as

- A. Residual income.
- B. Sunk costs.
- C. Separable costs.
- D. Opportunity costs.

**Answer: D**

Opportunity cost is the net benefit that could be obtained from the best alternative use of a resource. Accordingly, it is the benefit forgone by using that resource in a particular way.

**QUESTION: 252**

A manufacturer has been approached by a new customer who wants to place a one-time order for a component similar to one that the manufacturer makes for another customer. Existing sales will not be affected by acceptance of this order. The manufacturer has a policy of setting its targeted selling price at 60% over full manufacturing cost. The manufacturing costs and the targeted selling price for the existing product are presented below.

Direct materials	US \$ 2.30
Direct labor	3.60
Variable manufacturing overhead (applied at 75% of direct labor cost)	2.70
Fixed manufacturing overhead (applied at 150% of direct labor cost)	5.40
Total manufacturing cost	US \$14.00
Markup (60% of full manufacturing cost)	8.40
Targeted selling price	<u>US \$22.40</u>

The manufacturer has excess capacity to produce the quantity of the component desired by the new customer. The direct materials used in the component for the new customer would cost the manufacturer US \$0.25 less than the component currently being made. The variable selling expenses (packaging and shipping) would be the same, or US \$0.90 per unit. Under those circumstances, the minimum unit price at which the manufacturer would accept the special order is one exceeding.

- A. US \$8.35
- B. US \$9.25
- C. US \$14.00
- D. US \$14.80

**Answer: B**

Because the manufacturer has excess capacity and existing sales will be unaffected, the minimum price the manufacturer should be willing to accept is anything above the total variable cost of the unit (US \$2.05 + \$3.60 + \$2.70 + \$0.90 = US \$9.25). an amount that includes the variable manufacturing cost and the variable selling expenses. The fixed costs are not relevant.



**QUESTION: 253**

A company produced and sold 100,000 units of a component with a variable cost of US \$20 per unit. Of the units produced, 1,200 failed the company's tolerance specifications and were reworked at a cost of US \$12 per unit. Reworked units were sold as factory seconds at US \$45 each and first-quality units were sold at US \$50 each. If the company had implemented a quality assurance program to ensure that all units produced conformed to specifications, the increase in the company's contribution margin from this component would have been

- A. US \$14,400
- B. US \$20,400
- C. US \$21,600
- D. US \$39,600

**Answer: B.**

Both the cost of rework and the income lost when units were sold as factory seconds rather than first-quality units need to be included in the calculation. The following is the appropriate calculation:  $[(US \$12 + \$50 - \$45)] \times 1,200 = US \$20,400$ .

**QUESTION: 254**

A company has excess capacity in production-related fixed assets. If in a given year these fixed assets were being used to only 80 percent of capacity and the sales level in that year was US \$2,000,000, the full capacity sales level is

- A. US \$1,600,000
- B. US \$2,000,000
- C. US \$2,500,000
- D. US \$10,000,000

**Answer: C**

Full capacity sales can be calculated as follows: Actual sales - percent of capacity at which fixed assets were operated =  $US \$2,000,000 - 80 = US \$2,500,000$ .

**QUESTION: 255**

Which of the following costs are not relevant in a special-order decision?

- A. Incremental costs.
- B. Opportunity costs.



- C. Outlay costs.
- D. Sunk costs.

**Answer: D**

Sunk costs are always irrelevant because they occurred in the past

**QUESTION: 256**

An entity has excess capacity in production-related property, plant, and equipment. If in a given year these assets are being used to only 80% of capacity and the sales level in that year is US \$2 million, the full capacity sales level is

- A. U S \$1,600,000
- B. US \$2,000,000
- C. US \$2,500,000
- D. U S \$10,000,000

**Answer: C**

Full capacity sales equals actual sales divided by the percentage of capacity at which PPEs were operated. Thus, full capacity sales equals US \$2,500,000 (\$2,000,000 ÷ 80%).

**QUESTION: 257**

A new advertising agency serves a wide range of clients including manufacturers, restaurants, service businesses, department stores, and other retail establishments. The accounting system the advertising agency has most likely adopted for its record keeping in accumulating costs is

- A. Job-order costing.
- B. Operation costing.
- C. Relevant costing.
- D. Process costing.

**Answer: A**

Job-order costing is used by organizations whose products or services are readily identified by individual units or batches. The advertising agency accumulates its costs by client. Job-order costing is the most appropriate system for this type of nonmanufacturing firm.

**QUESTION: 258**

In a company, products pass through some or all of the production departments during manufacturing, depending upon the product being manufactured. Direct material and direct labor costs are traced directly to the products as they flow through each production department. Manufacturing overhead is assigned in each department using separate departmental manufacturing overhead rates. The inventory costing method that the manufacturing company is using in this situation is

- A. Absorption costing.
- B. Activity-based costing.
- C. Backflush costing.
- D. Variable costing.

**Answer:** A

Absorption costing inventories all direct manufacturing costs and both variable and fixed manufacturing overhead (indirect) costs.

**QUESTION:** 259

Three commonly employed systems for product costing are termed job-order costing, operations costing, and process costing. Match the type of production environment with the costing method used.

	Job-Order Costing	Operations Costing	Process Costing
A.	Auto repair	Clothing manufacturer	Oil refining
B.	Loan processing	Drug manufacturing	Custom printing
C.	Custom printing	Paint manufacturing	Paper manufacturing
D.	Engineering design	Auto assembly	Motion picture production

**Answer:** A

Job-order costing is appropriate when producing products with individual characteristics and/or when identifiable groupings are possible. Process costing should be used to assign costs to similar products that are mass produced on a continuous basis. Operations costing is a hybrid of job order and process costing systems. It is used by companies that manufacture goods that undergo some similar and some dissimilar processes. Thus, job-order costing would be appropriate for auto repair, operations costing for clothing manufacturing, and process costing for oil refining.

**QUESTION:** 260

A corporation manufactures two brands of barbed wire fencing for sale to wholesalers and large ranchers. Which of the following would be the best type of costing system for such a company to use?

- A. E OQ system.
- B. Job-order system
- C. Process system
- D. Retail inventory system.

**Answer: C**

A process costing system is used when a company mass produces a standardized product on a continuous basis. The production department becomes the cost center.

**QUESTION: 261**

A company services office equipment. Some customers bring their equipment to the company's service shop; other customers prefer to have the company's service personnel come to their offices to repair their equipment. The most appropriate costing method for the company is

- A. A job-order costing system.
- B. An activity-based costing system.
- C. A process costing system.
- D. An operation costing system.

**Answer: A**

Job-order costing systems are designed to accumulate costs for tasks or projects that are unique and non repetitive. Service organizations are interested in identifying the costs applicable to each customer and/or each service.

**QUESTION: 262**

Companies characterized by the production of basically homogeneous products will most likely use which of the following methods for the purpose of averaging costs and providing management with unit-cost data?

- A. Job-order costing.
- B. Direct costing.
- C. Absorption costing.
- D. Process costing.

**Answer: D**

Like products that are mass produced should be accounted for using process costing techniques to assign costs to products. Costs are accumulated by departments or cost centers rather than by jobs, work-in-process is stated in terms of equivalent units, and unit costs are established on a departmental basis. Process costing is an averaging process that calculates the average cost of all units.

**QUESTION: 263**

The loan department of a financial corporation makes loans to businesses. The costs of processing these loans are often several thousand dollars. The costs for each loan, which include labor, telephone, and travel, are significantly different across loans. Some loans require the use of outside services such as appraisals, legal services, and consulting services, whereas other loans do not require these services. The most appropriate cost accumulation method for the loan department of the corporation is

- A. Job-order costing.
- B. Process costing.
- C. Differential costing.
- D. Joint product costing.

**Answer: A**

Job-order costing is used by companies whose products or services are readily identified by individual units or a specific job, each of which receives varying amounts and types of input. The dissimilarity of the various loan services provided make... job-order costing appropriate.

**QUESTION: 264**

A corporation provides management consulting services to hospitals. Consulting engagements vary widely from hospital to hospital, both in terms of the nature of the consulting services provided and the scope of the consulting engagements. The most appropriate product costing system for the corporation is a

- A. Process costing system.
- B. Job-order costing system.
- C. Operation costing system.
- D. Just-in-time costing system.

**Answer: B.**

The job-order cost system of accounting is appropriate when producing products with

individual characteristics and/or when identifiable groupings are possible, e.g., batches of certain styles or types of furniture. The unique aspect of job-order costing is the identification of costs to specific units or a particular job. A job-order system is appropriate in consulting because of the substantial variation between engagements.

**QUESTION: 265**

A company employs a process cost system using the first-in, first-out (FIFO) method. The product passes through both Department 1 and Department 2 in order to be completed. Units enter Department 2 upon completion in Department 1. Additional direct materials are added in Department 2 when the units have reached the 25% stage of completion with respect to conversion costs. Conversion costs are added proportionally in Department 2. The production activity in Department 2 for the current month was as follows:

Beginning work-in-process inventory (40% complete with respect to conversion costs)	15,000
Units transferred in from Department 1	<u>80,000</u>
Units to account for	<u>95,000</u>
Units completed and transferred to finished goods	85,000
Ending work-in-process inventory (20% complete with respect to conversion costs)	<u>10,000</u>
Units accounted for	<u>95,000</u>

How many equivalent units for direct materials were added in Department 2 for the current month?

- A. 70,000 units
- B. 80,000 units
- C. 85,000 units.
- D. 95,000 units.

**Answer: A**

Beginning inventory is 40% complete. Hence, direct materials have already been added. Ending inventory has not reached the 25% stage of completion, so direct materials have not yet been added to these units. Thus, the equivalent units for direct materials calculated on a FIFO basis are equal to the units started and completed in the current period (85,000 units completed - 15,000 units in BWIP = 70,000 units started and completed). A manufacturing company employs a process cost system. The company's product passes through both Department 1 and Department 2 in order to be completed. Conversion costs are incurred uniformly throughout the process in Department 2. The direct material is added in Department 2 when conversion is 80% complete. This direct material is a preservative that not change the volume. Spoiled units are discovered at the final inspection and are recognized then for costing purposes. The physical flow of units for the current month is presented below.

Beginning work-in-process in Department 2 (90% complete with respect to conversion costs)	14,000
Transferred in from Department 1	76,000
Completed and transferred to finished goods	80,000
Spoiled units – all normal	1,500
Ending work-in-process in Department 2 (60% complete with respect to conversion costs)	8,500

**QUESTION: 266**

If the manufacturing company uses the weighted-average method, the equivalent units for direct materials in Department 2 for the current month would be

- A. 67,500
- B. 80,000
- C. 81,500
- D. 90,000

**Answer: C**

The weighted-average method does not distinguish between work done currently and in the prior period. Given that materials are added when units are 80% complete, that ending work-in-process is 60% complete, and that goods are inspected when they are 100% complete, and assuming that equivalent units are calculated for normal spoilage, the total weighted-average equivalent units for direct materials equals 81,500 (80,000 units transferred + 1,500 normally spoiled units). A manufacturing company employs a process cost system. The company's product passes through both Department 1 and Department 2 in order to be completed. Conversion costs are incurred uniformly throughout the process in Department 2. The direct material, added in Department 2 when conversion is 80% complete. This direct material is a preservative that does not change the volume. Spoiled units are discovered at the final inspection and are recognized then for costing purpose. The physical flow of units for the current month is presented below.

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Transferred in from Department 1	76,000
Completed and transferred to finished goods	80,000
Spoiled units – all normal	1,500
Ending work-in-process in Department 2 (60% complete with respect to conversion costs)	8,500

**QUESTION: 267**

If the manufacturing company uses the FIFO (first-in, first-out) method, the equivalent units for conversion costs in Department 2 for the current month would be

- A. 72,500
- B. 74,000
- C. 85,200
- D. 86,600

**Answer:** B.

The FIFO method distinguishes between work done in the prior period and work done currently. The total FIFO equivalent units equals the work done currently on beginning work-in-process, plus the work done on ending work-in-process, plus all units started and completed currently. Hence, total FIFO equivalent units equals  $74,000 (10\% \times 14,000 \text{ units in BWIP}) + 60\% \times 8,500 \text{ units in EWIP}) + [100\% \times 81,500 \text{ spoiled and transferred} - 14,000 \text{ units in BWIP}]$  A company harvests, packs, and ships all of its own produce. The company operates three packing lines. A summary of completed inventory costs is as follows:

Packing-line employee salary expense	US \$150,000
Packing-line supervision salary expense	90,000
Quality control salary expense	30,000
Packing crates expense	15,000
Electricity expense	3,000
Depreciation expense	66,000

**QUESTION:** 268

Costs for the packing lines would be accumulated in part by

- A. recording payroll expense by employee job category.
- B. Computing depreciation expense
- C. Producing monthly financial statements
- D. Forecasting monthly material shortages

**Answer:** A

Cost accumulation is performed by accounting systems that organize data by an appropriate catalog. actual costs, rather than predicted costs, are accumulated. a company harvests, packs, and ships all of its own produce. the company operates three packing lines a summary of completed inventory costs is as follows:

Packing-line employee salary expense	US \$150,000
Packing-line supervision salary expense	90,000
Quality control salary expense	30,000
Packing crates expense	15,000
Electricity expense	3,000
Depreciation expense	66,000

**QUESTION: 269**

At the end of the reporting period, 600,000 units had been packed and shipped. No inventory remained on hand. If the company used process costing, the cost per unit would be

- A. US \$0.197
- B. US \$0.275
- C. US \$0.315
- D. US \$0.590

**Answer: D**

Process costing is used to assign costs to products or services. It is relatively homogeneous items that are mass produced on a continuous basis. Process costing is the average cost per unit produced, or total cost divided by the number of units (US \$150,000 + \$90,000 + \$15,000 + \$3,000 + \$66,000 = US \$354,000 ÷ 600,000 = US \$0.59). Ramseur Company employs a process costing system for its two-department manufacturing operation using the first-in, first-out (FIFO) inventory method. When units are completed in Department 1, they are transferred to Department 2 for completion. Inspection takes place in Department 2 immediately before the direct materials are added, when the process is 70% complete with respect to conversion. The specific identification method is used to account for lost units. The number of defective units (that is, those failing inspection) is usually below the normal tolerance limit of 4% of units inspected. Defective units have minimal value, and the company sells them without any further processing for whatever it can. Generally, the amount collected equals, or slightly exceeds, the transportation cost. A summary of the manufacturing activity for Department 2, in units for the current month, is presented in the next column.

	<u>Physical Flow (output units)</u>
Beginning inventory (60% complete with respect to conversion)	20,000
Units transferred in from Department 1	<u>180,000</u>
Total units to account for	<u>200,000</u>
Units completed in Department 2 during the month	170,000
Units found to be defective at inspection	5,000
Ending inventory (80% complete with respect to conversion)	<u>25,000</u>
Total units accounted for	<u>200,000</u>

**QUESTION: 270**

Ramseur's equivalent units for direct materials for the current month would be



- A. 175,000 units.
- B. 181,500 units.
- C. 195,000 units.
- D. 200,000 units.

**Answer: C**

The equivalent units for direct materials equals 195,000 units (20,000 BWIP + 150,000 units started and completed + 25,000 EWIP). This calculation recognizes that direct materials had not been added to beginning inventory (60% complete) and spoiled units (70% complete), but that ending inventory (80% complete) includes direct materials. Ramseur Company employs a process costing system for its two-department manufacturing operation using the first-in, first-out (FIFO) inventory method. When units are completed in Department 1, they are transferred to Department 2 for completion. Inspection takes place in Department 2 immediately before the direct materials are added, when the process is 70% complete with respect to conversion. The specific identification method is used to account for lost units. The number of defective units (that is, those failing inspection) is usually below the normal tolerance limit of 4% of units inspected. Defective units have minimal value, and the company sells them without any further processing for whatever it can. Generally, the amount collected equals, or slightly exceeds, the transportation cost. A summary of the manufacturing activity for Department 2, in units for the current month, is presented in the next column.

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Ending inventory (80% complete with respect to conversion)	<u>25,000</u>
Total units accounted for	<u><u>200,000</u></u>

**QUESTION: 271**

The units that failed inspection during the month would be classified by Ramseur as

- A. Abnormal spoilage.
- B. Normal scrap.
- C. Normal reworked units.
- D. Normal waste.

**Answer: B.**

The units that failed inspection are classified as normal scrap because they have minimal value and can be sold without further reworking. The defective units are less than the 4% tolerance limit for normal spoilage. Scrap can be sold, disposed of, or reused.

**QUESTION: 272**

In a process-costing system, the cost of abnormal spoilage should be

- A. Prorated between units transferred out and ending inventory
- B. Included in the cost of units transferred out.
- C. Treated as a loss in the period incurred.
- D. Ignored.

**Answer: C**

Abnormal spoilage is spoilage that is not expected to occur under normal, efficient operating conditions. Because of its unusual nature, abnormal spoilage is typically treated as a loss in the period in which it is incurred. Believing that its traditional cost system may be providing misleading information, an organization is considering an activity-based costing (ABC) approach. It now employs a full cost system and has been applying its manufacturing overhead on the basis of machine hours. The organization plans on using 50,000 direct labor hours and 30,000 machine hours in the coming year. The following data show the manufacturing overhead that is budgeted.

<u>Activity</u>	<u>Cost Driver</u>	<u>Budgeted Activity</u>	<u>Budgeted Cost</u>
Material handling	No. of parts handled	6,000,000	US \$ 720,000
Setup costs	No. of setups	750	315,000
Machining costs	Machine hours	30,000	540,000
Quality control	No. of batches	500	225,000
Total manufacturing overhead cost:			<u><u>US \$1,800,000</u></u>

Cost, sales, and production data for one of the organization's products for the coming year are as follows:

Prime costs:

Direct material cost per unit	US \$4.40
Direct labor cost per unit (.05 DLH @ US \$15.00/DLH)	.75
Total prime cost	<u>US \$5.15</u>

Sales and production data:

Expected sales	20,000 units
Batch size	5,000 units
Setups	2 per batch
Total parts per finished unit	5 parts
Machine hours required	80 MH per batch

**QUESTION: 273**

If the organization uses the traditional full cost system, the cost per unit for this product for the coming year will be

- A. US \$5.39
- B. US \$5.44
- C. US \$6.11
- D. US \$6.95

**Answer: C**

Given that manufacturing overhead is applied on the basis of machine hours, the overhead rate is US \$60 per hour  $(\$1,800,000 \div 30,000)$  or US \$.96 per unit  $[80 \text{ machine hours per batch} \times \$60] \div 5,000 \text{ units per batch}$ . Accordingly, the unit full cost is US \$6.11  $(\$5.15 \text{ unit prime cost} + \$.96)$ . Believing that its traditional cost system may be providing misleading information, an organization is considering an activity-based costing (ABC) approach. It now employs a full cost system and has been applying its manufacturing overhead on the basis of machine hours. The organization plans on using 50,000 direct labor hours and 30,000 machine hours in the coming year. The following data show the manufacturing overhead that is budgeted.

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Total prime cost	<u>US \$5.15</u>
<u>Sales and production data:</u>	
Expected sales	20,000 units
Batch size	5,000 units
Setups	2 per batch
Total parts per finished unit	5 parts
Machine hours required	80 MH per batch

**QUESTION: 274**

If the organization employs an activity-based costing system, the cost per unit for the product described for the coming year will be

- A. US \$ 6.00
- B. US \$ 6.08
- C. US \$ 6.21
- D. US \$ 6.30

**Answer: D**

Materials handling cost per part is US \$.12 (720,000 / 6,000,000), cost per setup is US \$420 (315,000 / 750), machining cost per hour is US \$18 (540,000 / 30,000), and quality cost per batch is U. 700 (225,000 / 500). Hence, total manufacturing overhead applied is US \$22,920 [(5 parts per unit) x 20,000 units x \$.12) + (4 batches x 2 setups per batch x \$420 + 4 batches x 80 machine hours per batch x \$18 + 4 batches \$450)]. The total unit cost is US \$6.216 [\$5.15 prime cost + \$22,920 / 20,000 units) overhead].

**QUESTION: 275**

Which of the following would be a reasonable basis for allocating the material handling costs to the units produced in an activity-based costing system?

- A. Number of production runs per year.
- B. Number of components per completed unit.
- C. Amount of time required to produce one unit.
- D. Amount of overhead applied to each completed unit.

**Answer: B.**

An essential element of activity-based costing (ABC) is driver analysis, which identifies the cause-and-effect relationship between an activity and its consumption of resources and for an activity and the demands made on it by a cost object. There is a direct causal relationship between the number of components in a finished product and the amount of material handling cost incurred.

**QUESTION: 276**

Cost allocation is the process of assigning indirect costs to a cost object. The indirect costs are grouped in cost pools and then allocated by a common allocation base to the cost object. The base that is employed to allocate a homogeneous cost pool should.

- A. Have a cause-and-effect relationship with the cost items in the cost pool.
- B. Assign the costs in the pool uniformly to cost objects even if the cost objects use resources in a nonuniform way.
- C. Be a nonfinancial measure (e.g., number of setups) because a nonfinancial measure is more objective.
- D. Have a high correlation with the cost items in the cost pool as the sole criterion for selection.

**Answer: A**

A cost allocation base is the common denominator for systematically correlating indirect costs and a cost object. The cost driver of the indirect costs is ordinarily the allocation base. In a homogeneous cost pool, all costs should have the same or a similar cause-and-effect relationship with the cost allocation base.

**QUESTION: 277**

A company with three products classifies its costs as belonging to five functions: design, production, marketing, distribution, and customer services. For pricing purposes, all company costs are assigned to the three products. The direct costs of each of the five functions are traced directly to the three products. The indirect costs of each of the five business functions are collected into five separate cost pools and then assigned to the three products using appropriate allocation bases. The allocation base that will most likely be the best for allocating the indirect costs of the distribution function is

- A. Number of customer phone calls.
- B. Number of shipments.
- C. Number of sales persons.
- D. Dollar sales volume.

**Answer: B.**

The number of shipments is an appropriate cost driver. A cause-and-effect relationship may exist between the number of shipments and distribution costs.

**QUESTION: 278**

Which of the following statements about activity-based costing (ABC) is false?

- A. Activity-based costing is useful for allocating marketing and distribution costs.
- B. Activity-based costing is more likely to result in major differences from traditional costing systems if the firm manufactures only one product rather than multiple products.
- C. In activity-based costing, cost drivers are what cause costs to be incurred.
- D. Activity-based costing differs from traditional costing systems in that products are cross-subsidized.

**Answer: B.**

ABC determines the activities that will serve as cost objects and then accumulates a cost pool for each activity using the appropriate activity base (cost driver). It is a system that may be employed with job order or process costing methods. Thus, when there is only one product, the allocation of costs to the product is trivial. All of the cost is assigned to the one product; the particular method used to allocate the costs does not matter.

**QUESTION: 279**

Which of the following techniques would be best for evaluating the management performance of a department that is operated as a cost center?

- A. Return on assets ratio.
- B. Return on investment ratio.
- C. Payback method.
- D. Variance analysis.

**Answer: D**

A cost center is a responsibility center that is responsible for costs only. Of the alternatives given, variance analysis is the only one that can be used in a cost center. Variance analysis involves comparing actual costs with predicted or standard costs.

**QUESTION: 280**

The receipt of raw materials used in the manufacture of products and the shipping of finished goods to customers is under the control of the warehouse supervisor. The warehouse supervisor's time is spent approximately 60% on receiving activities and 40% on shipping activities. Separate staffs for the receiving and shipping operations are

employed. The labor-related costs for the warehousing function are as follows:

Warehouse supervisor's salary	US \$ 40,000
Receiving clerks' wages	75,000
Shipping clerks' wages	55,000
Employee benefit costs (30% of wage and salary costs)	<u>51,000</u>
	<u><u>US \$221,000</u></u>

The company employs a responsibility accounting system for performance reporting purposes. The costs are classified on the report as period or product costs. The total labor-related costs that would be listed on the responsibility accounting performance report as product costs under the control of the warehouse supervisor for the warehousing function would be

- A. US \$97,500
- B. US \$128,700
- C. US \$130,000
- D. 115 X771 000

**Answer: A**

The responsibility accounting report should list only the costs over which the warehousing supervisor exercises control. The supervisor's salary should therefore be excluded because it is controlled by the warehouse supervisor's superior. Moreover, only the product costs are to be considered. These exclude the shipping clerks' wages and fringe benefits because they are period costs (shipping is a selling expense). Thus, the only product cost under the control of the warehouse supervisor is the receiving clerks' wages (US \$75,000) and the related fringe benefits (US \$75,000 x 30% = \$22,500), or a total of US \$97,500.

**QUESTION: 281**

Making segment disclosures is an advantage to a company because it.

- A. Facilitates evaluation of company management by providing 1 data on particular segments.
- B. Eliminates the interdependence of segments.
- C. Masks the effect of intersegment transfers.
- D. Provides competitors with comparative information on the company's performance.

**Answer: A**

Segment reporting is an aspect of responsibility accounting. It facilitates evaluation of company management and of the quality of the economic Investment in particular

segments.

**QUESTION: 282**

When comparing the residual income of several investment centers, the validity of comparisons may be destroyed by

- A. Peculiarities of each investment center.
- B. Differences in the relative amount of income.
- C. Consistent use of an imputed interest rate.
- D. Common amounts of invested capital for each investment center.

**Answer: A**

Residual income is income of an investment center, minus an imputed interest charge for invested capital. The theory is that earning an income greater than residual income indicates that expansion is desirable. However, comparisons of investment centers based on residual income may be misleading because of differences in products, markets, costs, and local conditions.

**QUESTION: 283**

Residual income is often preferred over return on investment (ROI) as a performance evaluation because

- A. Residual income is a measure over time while ROI represents the results for a single time period.
- B. Residual income concentrates on maximizing absolute amounts of income rather than a percentage return as with ROI.
- C. The imputed interest rate used in calculating residual income is more easily derived than the target rate that is compared to the calculated ROI.
- D. Average investment is employed with residual income while year-end investment is employed with ROI.

**Answer: B.**

Residual income concentrates on earnings in excess of the minimum desired return. With ROI, a segment may reject a project that exceeds the minimum return if the project will decrease the segment's overall ROI. For example, a project that earns an ROI of 22%, which is greater than the target rate of 20%, might be rejected if the segment is currently earning 25%. because the project will decrease the segments ROI. This would not occur if performance was measured using residual income.



**QUESTION: 284**

Overtime conditions and pay were recently set by the human resources department. The production department has just received a request for a rush order from the sales department. The production department protests that additional overtime costs will be incurred as a result of the order. The sales department argues that the order is from an important customer. The production department processes the order. To control costs, which department should never be charged with the overtime costs generated as a result of the rush order?

- A. Human resources department.
- B. Production department.
- C. Sales department
- D. Shared by production department and sales department.

**Answer: A**

The sales department should be responsible for the overtime costs because it can best judge whether the additional cost of the rush order is justified. The production department also may be held responsible for the overtime costs because charging the full overtime cost to the sales department would give the production department no incentive to control these costs. However, the human resources department would never be charged with the overtime costs because it has no effect on the incurrence of production overtime.

**QUESTION: 285**

Which of the following is not true of responsibility accounting?

- A. Managers should only be held accountable for factors over which they have significant influence.
- B. The focus of cost center managers will normally be more narrow than that of profit center managers.
- C. Every factor that affects a firm's financial performance ultimately is controllable by someone, even if that someone is the person at the top of the firm.
- D. When a responsibility account system exists, operations of the business are organized into separate areas controlled by individual managers.

**Answer: C**

Responsibility accounting stresses that managers are responsible only for factors under their control. For this purpose, the operations of the business are organized into responsibility centers. Costs are classified as controllable and uncontrollable. This implies that some revenues and costs can be changed through effective management. Management may then focus on deviations for either reinforcement or correction. Thus, the statement that every factor is ultimately controllable by someone is

not a premise of responsibility accounting.

**QUESTION: 286**

A company plans to implement a bonus plan based on segment performance. In addition, the company plans to convert to a responsibility accounting system for segment reporting. The following costs, which have been included in the segment performance reports that have been prepared under the current system, are being reviewed to determine if they should be included in the responsibility accounting segment reports:

- I. Corporate administrative costs allocated on the basis of net segment sales.
- II. Personnel costs assigned on the basis of the number of employees in each segment
- III. Fixed computer facility costs divided equally among each segment
- IV. Variable computer operational costs charged to each segment based on actual hours used times a predetermined standard rate; any variable cost efficiency or inefficiency remains in the computer department. Of these four cost items, the only item that could logically be included in the segment performance reports prepared on a responsibility accounting basis would be the

- A. Corporate administrative costs.
- B. Personnel costs.
- C. Fixed computer facility costs.
- D. Variable computer operational costs.

**Answer: D**

The variable computer cost can be included. The segments are charged for actual age, which is under each segment's control. The predetermined standard rate is set at the beginning of the year and is known by the segment managers. Moreover efficiencies and inefficiencies of the computer department are not passed on to the segments. Both procedures promote a degree of control by the segments.

**QUESTION: 287**

In a responsibility accounting system, managers are accountable for

- A. Variable costs but not for fixed costs.
- B. Product costs but not for period costs.
- C. Incremental costs.
- D. Costs over which they have significant influence.

**Answer: D**

The most desirable measure for evaluating a departmental manager is one that holds the manager responsible for the revenues and expenses s/he can control.

Controllability is the basic concept of responsibility accounting.

**QUESTION: 288**

Return on investment (ROI) is a very popular measure employed to evaluate the performance of corporate segments because it incorporates all of the major ingredients of profitability (revenue, cost, investment) into a single measure. Under which one of the following combinations of actions regarding a segment's revenues, costs, and investment would a segment's ROI always increase?

	<u>Revenues</u>	<u>Costs</u>	<u>Investments</u>
A.	Increase	Decrease	Increase
B.	Decrease	Decrease	Decrease
C.	Increase	Increase	Increase
D.	Increase	Decrease	Decrease

**Answer: D**

An increase in revenue and a decrease in costs will increase the ROI numerator. A decrease in investment will decrease the denominator. The ROI must increase in this situation.

Section 2: Sec Two (289 to 299)

Details: Finance

**QUESTION: 289**

Regulatory agencies usually do not have power to

- A. Impose agency taxes on private industry.
- B. Issue rules and regulations.
- C. Investigate violations of statutes and rules.
- D. Conduct hearings and decide whether violations have occurred.

**Answer : A**

A regulatory agency may regulate some aspect of all industries or may regulate a specific industry in accordance with power delegated by the enabling legislation. Agency functions include executive, adjudicatory, and rule-making activities. Such agencies, however, may not impose taxes.

**QUESTION: 290**

The basic purpose of most national securities laws is to regulate the issue of investment securities by

- A. Providing a regulatory framework for those 1<sup>st</sup>-world governments that do not have their own securities laws.
- B. Requiring disclosure of all relevant facts so that investors can make informed decisions.
- C. Prohibiting the issuance of securities that the government determines are not of investment grade.
- D. Channeling investment funds into uses that are economically most important.

**Answer : B.**

The basic purpose of the securities laws is to provide disclosure of adequate information so that investors can evaluate investments. This is accomplished through reporting requirements concerning the issuance and subsequent trading of securities. However, the government does not assess the merits of these securities.

**QUESTION: 291**

An antifraud law that prohibits trading on the basis of inside information about a business corporation's stock most likely applies to

- A. Officers and directors.
- B. All officers, directors, and shareholders.
- C. Officers, directors, and holders of a large amount of the corporation's stock.
- D. Anyone who bases his/her trading activities on the inside information.

**Answer : D**

Such antifraud provisions typically prohibit any person from engaging in manipulative or deceptive acts in the purchase or sale of any security. It prohibits trading on the basis of inside information and applies to anyone who has not made a full disclosure of the inside information. It may apply not only to officers, directors, and shareholders, but also to tippees, i.e., those who receive inside information from insiders.

**QUESTION: 292**

Antitrust laws are intended to

- A. Establish set profit percentages for entities in regulated industries.
- B. Prohibit entities in the same industry from engaging in joint ventures.
- C. Require entities in regulated industries to share any patent rights with other entities in that industry.
- D. Ensure a free and competitive market in which consumer demand dictates prices.

**Answer : D**

Antitrust laws are designed to promote more efficient allocation of resources, greater choice for consumers, greater business opportunities, fairness in economic behavior, and avoidance of concentrated political power resulting from economic power. Competition results in greater output and lower prices than other market structures.

**QUESTION: 293**

Which one of the following examples of corporate behavior would most clearly represent a violation of antitrust law?

- A. A retailer offers quantity discounts to large institutional buyers.
- B. The members of a labor union meet and agree not to work for a specific entity unless the starting wage is at least a specified amount per hour.
- C. Two entities that are in different, unrelated industries merge.
- D. Two entities in the same industry agree in a telephone conversation to submit identical bids on a government contract.

**Answer : D**

Antitrust law addresses restraints of trade. Some types of arrangements are considered automatic violations. These violations may include price fixing, division of markets, group boycotts, and resale price maintenance. Agreeing to submit identical bids on a government contract is a form of price fixing.

**QUESTION: 294**

Tie-in sales e.g., the sale of camera and film together) most likely are legal if

- A. The tie-in is necessary to assure product quality.
- B. The tying product is patented.
- C. Used to facilitate price discrimination.
- D. Used by all entities in an industry.

**Answer : A**

Tie-in sales involve a seller's requirement that the buyer purchase another distinct product to obtain the first. They are usually prohibited under antitrust law unless a small entity is attempting to enter a market or the tie-in is needed to protect the entity's goodwill e.g., by maintaining a certain quality standard). Tie-in sales requirements are usually illegal if the seller has enough market power to restrict competition.

**QUESTION: 295**

Consumer protection regulations have resulted in all of the following except

- A. Food label laws requiring a list of ingredients and nutritional data.
- B. Product safety laws that establish the liability of producers of unsafe or defective products.
- C. Rules allowing the award of monetary damages to persons injured by false and misleading advertising.
- D. Truth-in-lending requirements that lenders must identify the total dollars to be paid by the borrower over the term of the loan.

**Answer : C**

Statutes often provide for regulation of the matters listed in a). b). and d). respectively. To date, no legislation allows the award of monetary damages to persons injured by false and misleading advertising. However, laws may prohibit unfair or deceptive acts in commerce. including false or misleading advertising.

**QUESTION: 296**

Truth-in-lending laws most likely are intended to

- A. Regulate the amount of interest that may be charged.
- B. Allow immediate wage garnishment by creditors.
- C Prohibit the use of usurious interest rates.
- D Disclose the finance charge and the annual percentage rate.

**Answer : D**

Truth-in-lending laws are disclosure statutes. They typically apply to creditors that extend consumer credit to individual debtors. Examples of disclosures for a closed-end credit transaction, e.g., the typical car loan, include the total finance charge, annual percentage interest rate, amount financed, late charges, security interest held by the creditor, the number and amounts of payments, due dates, and the total amount of payments.

**QUESTION: 297**

The general approach to regulation by consumer product safety laws is to

- A. Levy fines against the producers of unsafe products.
- B. Set safety standards for various products.

- C. Increase the freedom of consumer choice.
- D. Depend upon voluntary action by manufacturers to produce safe products.

**Answer : B**

These laws promote voluntary safety standards, develop and enforce mandatory standards, prohibit unsafe products if safety standards will not be sufficient, recall hazardous products, furnish information to consumers, and work with local governments. Thus, the emphasis is the prevention of problems through standard setting, not the punishment of wrongdoers.

**QUESTION: 298**

The primary reason for social regulation is that

- A. The free market provides minimal safety and environmental protection.
- B. Consumer and environmental groups are politically powerful.
- C. Social al benefits from such regulations always exceed the costs.
- D. Social regulation is more desirable.

**Answer : A**

Social regulation concerns quality of life issues, e.g., workplace and product safety, environmental degradation, and fair employment practices. The abuses addressed are those that are difficult for market forces to remedy. For example, consumers may purchase products on the basis of price and quality but without regard to the environmental impact of their production, and unsafe working conditions may be tolerated by individuals who have few opportunities for other employment.

**QUESTION: 299**

An environmental regulatory body might control pollution by setting effluent standards for maximum discharge or by constructing a sliding-tax charge based on the amount of effluent emitted. One advantage of the sliding-tax charge is that

- A. It will totally eliminate pollution.
- B. There is greater business incentive to discover new methods of controlling pollution.
- C. It increases the necessity for the regulatory body to fully understand pollution control technology.
- D. It increases the degree of direct government intervention in the economy.

**Answer : B.**

The setting of effluent standards has been criticized as inefficient. Economists prefer a

sliding tax based on the amount of effluent emitted. This method is preferable because, as effluent discharge increases, the tax increases, providing an incentive for entities to discover new methods of controlling pollution. Rather than dictating technology, the tax allows entities to seek out the technology that is the most cost effective.



**QUESTION: 1**

If a central bank wishes to implement an expansionary monetary policy, which one of the following actions would it take?

- A. Raise the reserve requirement and the rate at which member banks may borrow from the central bank.
- B. Purchase additional government securities and lower the rate at which member banks may borrow from the central bank.
- C. Reduce the reserve requirement and raise the rate at which member banks may borrow from the central bank.
- D. Raise the rate at which member banks may borrow from the central bank and sell government securities.

**Answer : B**

A central bank affects monetary policy primarily through the purchase and sale of government securities. A purchase of securities is expansionary because it increases bank reserves and the money supply. However, the sale of government securities by the central bank contracts the money supply by removing resources from the economy. Lowering the reserve requirement (the percentage of deposits that a bank must keep on hand) also expands the money supply by increasing the loanable funds held by banks. Similarly, lowering the rate at which member banks may borrow from the central bank encourages borrowing and increases the money supply.

**QUESTION: 2**

A tight monetary policy is frequently cited as an important policy instrument for fighting inflation. Keynesian economists believe that one of the possible undesirable side effects of such a policy is

- A. Reduced business investment due to higher interest rates.
- B. Reduced business investment due to lower interest rates.
- C. Increased business investment due to decreased government spending.
- D. Increased business investment because of reduced confidence in business.

**Answer : A**

A tight monetary policy means that little money is available for borrowing. When supply is reduced, the price increases. Thus, interest rates are increased when the money supply contracts. Because of high interest rates, the cost of investment is increased and investment is discouraged.

**QUESTION: 3**

Which of the following is a tool of monetary policy that a nation's central bank could use to stabilize the economy during an inflationary period?

- A. Selling government securities.
- B. Lowering bank reserve requirements.
- C. Lowering bank discount rates.
- D. Encouraging higher tax rates.

**Answer : A**

Selling government securities is contractionary because it takes money out of circulation.

**QUESTION: 4**

The total exports of Vietnam are US \$20,000,000 worth of rice to Greece, and the total exports of Greece are US \$18,111,100 worth of olives to Vietnam. The terms of trade are

	<u>Greece</u>	<u>Vietnam</u>
A.	90	111
B.	120	180
C.	111	90
D.	97	103

**Answer : A**

A country's terms of trade are calculated by dividing its export price index by its import price index and multiplying by 100. Greece's total exports US \$18,000,000 divided by its total imports US \$20,000,000 equals  $0.9 \times 100 = 90$ . Vietnam's total exports US \$20,000,000 divided by its total imports US \$18,000,000 equals  $1.11 \times 100 = 111$ .

**QUESTION: 5**

The economic reasoning dictating that each nation specialize in the production of goods that it produces relatively more efficiently than other nations and import those goods that are produced relatively more efficiently by other nations is called the doctrine of

- A. Efficient trade.
- B. Diminishing returns.
- C. Relative competition.
- D. Comparative advantage.

**Answer : D**

The doctrine of comparative advantage relates to comparative costs within one country. It holds that a country should produce those products in which it has a comparative advantage, not necessarily those products in which it has an absolute advantage. The doctrine suggests that a country should produce those products for which the greatest efficiencies are attainable even if it could also produce other goods more efficiently than another nation. In the long run, importing a product in which a country has an absolute advantage but not a comparative advantage will result in an overall increase in global production.

**QUESTION: 6**

What is the economic term used to describe the situation in which each nation specializes in the production of goods that it produces relatively more efficiently than other nations and imports those goods that are produced relatively more efficiently by other nations?

- A. Balance of trade.
- B. Diminishing returns.
- C. Relative competition.
- D. Comparative advantage.

**Answer : D**

The relevant concept is comparative advantage, which compares the costs of inputs within a single country. In contrast, the concept of absolute advantage with respect of inputs between countries. It is possible that a country might have an absolute advantage, with respect to every product, but comparative advantage is different from absolute advantage. A particular nation can have a comparative advantage even though it does not

have an absolute advantage. For example assume that Country A can produce Item for US \$100 and Item Y for US \$200 and that Country B can produce Item X for US \$50 and Item Y for US \$150. B has an absolute advantage in the production of both products however, B has a comparative advantage in producing Item X 50 100, or 50% of the A cost compared with 150 200, or 75% of the A cost for Item Y). A has a comparative advantage in producing Item Y 200 150, or 133% of the B cost, versus 100 50, or 200% for Item X). A nation will benefit by exporting goods in which it has a comparative advantage and importing goods in which it does not have a comparative advantage. Total output will be maximized when each nation specializes in the products in which it has the greatest comparative advantage or the least comparative disadvantage.

**QUESTION: 7**

If the value of the U.S. dollar in foreign currency markets changes from US \$1 = .95 euros to US \$1 = .90 euros.

- A. The euro has depreciated against the dollar.
- B. Products imported from Europe to the U.S. will become more expensive.
- C. U.S. tourists in Europe will find their dollars will buy more European products.
- D. U.S. exports to Europe should decrease.

**Answer : B**

The dollar has declined in value relative to the euro. If an American had previously wished to purchase a European product that was priced at 10 euros, the price would have been about US \$10.53. After the dollar's decline in value, the price of the item has increased to about US \$11.11. Hence, imports from Europe should decrease and exports increase.

**QUESTION: 8**

Exchange rates are determined by

- A. Each industrial country's government.
- B. The International Monetary Fund.
- C. Supply and demand in the foreign currency market.
- D. Exporters and importers of manufactured goods.

**Answer : C**

Although currencies can be supported by various means for short periods, the primary determinant of exchange rates is the supply of and demand for the various currencies. Under current international agreements, exchange rates are allowed to "float." During periods of extreme fluctuations, however, governments and central banks may intervene to maintain stability in the market.

**QUESTION: 9**

Two countries have flexible exchange rate systems and an active trading relationship. If incomes in country 1, everything else being equal, then the currency of country 1 will tend to be stronger relative to the currency of country 2.

	List A	List B
A.	Rise	Remain constant
B.	Fall	Depreciate
C.	Rise	Depreciate
D.	Remain constant	Appreciate

**Answer : C**

If incomes in country 1 rise, consumers in country 1 will increase their imports from country 2. The resulting increase in the supply of currency 1 will result in a tendency for it to depreciate relative to the currency of country 2.

**QUESTION: 10**

If the exchange rate has changed from 1 local currency unit (LCU) to 5 foreign currency units (FCUs) to a rate of 1 LCU to 5.5 FCUs,

- A. The LCU has appreciated by 10%.
- B. The LCU has depreciated by 10%.
- C. The FCU has appreciated by 20%.
- D. The FCU has depreciated by 20%.

**Answer : A**

If the exchange rate changes from 1 LCU to 5 FCUs to 1 LCU to 5.5 FCUs, the LCU has appreciated by 10%  $[(5.5 - 5) / 5]$ .

**QUESTION: 11**

The value of the domestic currency in relation to foreign currencies is

- A. Determined directly by the price of gold because the value of the domestic currency is tied to the price of gold.
- B. Set by the domestic government in consultation with foreign governments.
- C. Set along with the value of other currencies held by the International Monetary Fund.
- D. Determined by the forces of supply and demand on the foreign exchange markets.

**Answer : D**

Exchange rates are determined by the forces of supply and demand on the exchange markets. Often other forces try to intervene in this process of exchange rate determination, but these reflect only short-run policies. An example of this type of policy would be government or central bank intervention in the international money markets.

**QUESTION: 12**

A domestic entity and a foreign entity purchased the same stock on the foreign stock exchange and held the stock for 1 year. The value of the foreign currency weakened against the domestic currency over this period. Comparing the returns of the two companies, what will be the domestic entity's return?

- A. Lower.
- B. Higher.
- C. The same.
- D. Higher in the short-run but lower in the long-run.

**Answer : A**

The returns on the stock are presumably paid in foreign currency. Hence, the change in the value of the foreign currency relative to the domestic currency does not affect the foreign entity's return. However, the weakening of the foreign currency reduces the amount of domestic currency it will buy, and the domestic entity's return in domestic currency is correspondingly reduced.

**QUESTION: 13**

If the central bank of a country raises interest rates sharply, the country's currency will likely

- A. Increase in relative value.
- B. Remain unchanged in value.
- C. Decrease in relative value.
- D. Decrease sharply in value at first and then return to its initial value.

**Answer : A**

Exchange rates fluctuate depending upon the demand for each country's currency. If a country raises its interest rates, its currency will appreciate. The demand for investment at the higher interest rates will shift the demand curve for the currency to the right. The reverse holds true for a decrease in interest rates

**QUESTION: 14**

Assuming that the real rate of interest is the same in both countries, if Country A has a higher nominal interest rate than Country B, the currency of Country A will likely be selling at a

- A. Forward discount relative to the currency of Country B.
- B. Forward premium relative to the currency of Country B.
- C. Spot discount relative to the currency of Country B.
- D. Spot premium relative to the currency of Country B.

**Answer : A**

If the real rates of interest are equal, the country with the higher nominal interest rate is expected to experience a higher rate of inflation. A higher rate of inflation is associated with a devaluing currency, so the currency of the country with the higher nominal interest rate will likely be selling at a forward discount.

**QUESTION: 15**

A German importer of English clothing has contracted to pay an amount fixed in British pounds 3 months from now. If the importer worries that the euro may depreciate sharply against the British pound in the interim, it would be well advised to

- A. Buy pounds in the forward exchange market.
- B. Sell pounds in the forward exchange market.
- C. Buy euros in the futures market.
- D. Sell euros in the futures market.

**Answer : A**

The importer should buy pounds now. If the euro depreciates against the pound in the next 90 days, the gain on the forward exchange contract would offset the loss from having to

pay more euros to satisfy the liability.

**QUESTION: 16**

An entity has a foreign-currency-denominated trade payable, due in 60 days. To eliminate the foreign currency exchange-rate risk associated with the payable, the entity could

- A. Sell foreign currency forward today.
- B. Wait 60 days and pay the invoice by purchasing foreign currency in the spot market at that time.
- C. Buy foreign currency forward today.
- D. Borrow foreign currency today, convert it to domestic currency on the spot market, and invest the funds in a domestic bank deposit until the invoice payment date.

**Answer : C**

The entity can arrange to purchase the foreign currency today rather than in 60 days by buying the currency in the forward market. This hedging transaction will eliminate the exchange-rate risk associated with the trade payable.

**QUESTION: 17**

Which of the following is a tariff?

- A. Licensing requirements.
- B. Consumption taxes on imported goods.
- C. Unreasonable standards pertaining to product quality and safety.
- D. Domestic content rules.

**Answer : B**

Tariffs are excise taxes on imported goods imposed either to generate revenue or protect domestic producers. Thus, consumption taxes on imported goods are tariffs.

**QUESTION: 18**

Which of the following is a direct effect of imposing a protective tariff on an imported product?

- A. Lower domestic prices on the imported item.
- B. Lower domestic consumption of the item.
- C. Reduced domestic production of the item.
- D. Higher sales revenues for foreign producers of the item.

**Answer : B**

A protective tariff adds to the purchase price of imported goods. If an imported good's sales price is higher than a comparable, less expensive domestic good, consumers will purchase the domestic good. Thus, the direct effect of imposing a protective tariff on an imported good is lower domestic consumption.

**QUESTION: 19**

A direct effect of imposing a protective tariff on an item for which there are both foreign and domestic producers is that domestic producers will sell, <List A> of the item while domestic consumers consume, <List B> of the item.

	<u>List A</u>	<u>List B</u>
A.	More	More
B.	More	Less
C.	Less	More
D.	Less	Less

**Answer : B**

Domestic producers are not subject to the tariff and will therefore have a price advantage over their foreign competitors. However, absent such competition, the domestic price of the item will be higher. Domestic producers will sell more at a higher price, and domestic consumers will consume less following the price increase.

**QUESTION: 20**

One consequence of the imposition of tariffs or quotas on imported products is

- A. Lower prices for domestic products that compete with affected imports.
- B. Domestic industry opposition to protection from imports.
- C. Additional consumption of the affected imported products.
- D. Higher prices for the affected imported products.

**Answer : D**

Tariffs lead to higher prices on imported products. Similarly, the imposition of quotas leads to higher prices through an artificial limitation on supply.

**QUESTION: 21**

Which one of the following groups would be the primary beneficiary of a tariff?

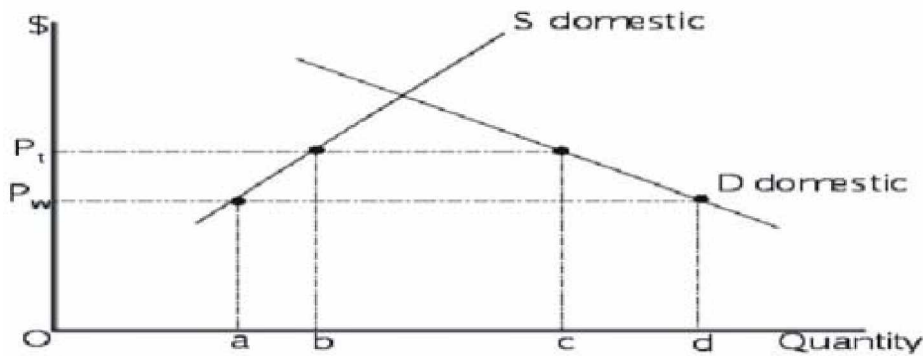
- A. Domestic producers of
- B. Domestic producers of goods protected by the tariff.
- C. Domestic consumers of goods protected by the tariff.
- D. Foreign producers of goods protected by the tariff.

**Answer : B**

Despite the advantages of free trade, nations often levy tariffs to discourage the importation of certain products. A tariff is a tax on imports intended to protect a domestic producer from foreign competition. For instance, a tariff on imported autos benefits domestic auto manufacturers because it is an additional cost imposed on domestic consumers of such products. The disadvantages of the tariff are that it may protect an inefficient domestic producer and increase prices paid by domestic consumers.

**QUESTION: 22**

The graph depicts the domestic supply of and demand for a product that is also sold in the domestic market by foreign producers. The domestic producers are protected by a tariff of the amount  $P_t$  minus  $P_w$ .  $P_t$  is the domestic price including the tariff, and  $P_w$  is the world price for the product. The effect of the tariff is to



- A. Reduce the domestic price from  $OR_w$  to  $OR_t$
- B. Reduce foreign sales in the domestic market from  $ac$  to  $bc$ .
- C. Increase domestic production from  $Ob$  to  $Cc$ .
- D. Increase domestic production from  $Oa$  to  $Ob$ .

**Answer : D**

Without the tariff, domestic production is determined by the intersection of the  $P_w$  line with the domestic supply curve at the quantity  $Oa$ . Domestic production increases from  $Oa$  to  $Ob$  as a result of the introduction of the tariff. Supply intersects the  $P_t$  line at a higher price and at a greater domestic quantity,  $Ob$ .

**QUESTION: 23**

Which of the following measures create the most restrictive barrier to exporting to a country?

- A. Tariffs
- B. Quotas.
- C. Embargoes.
- D. Exchange controls.

**Answer : C**

An embargo is a total ban on some kinds of imports. It is an extreme form of the import quota. Embargoes have the effect of totally excluding the exporting entity from selling in that country and are the most restrictive type of import/export law.

**QUESTION: 24**

Which of the following is an economic rationale for government intervention in trade?

- A. Maintaining spheres of influence.
- B. Protecting infant industries.
- C. Preserving national identity.
- D. Dealing with friendly countries.

**Answer : B**

The infant-industry argument contends that protective tariffs are needed to allow new domestic industries to become established. Once such industries reach a maturity stage in their life cycles, the tariffs can be removed.

**QUESTION: 25**

Government subsidies of the domestic production of military weapons is an



example of what rationale for government intervention in trade?

- A. Infant industry concept.
- B. Maintenance of essential industries.
- C. Maintenance of extension of spheres of influence.
- D. Protecting the national identity.

**Answer : B**

Providing subsidies to military weapons manufacturers is an example of the essential-industry argument. The government protects essential domestic industries during peacetime so that a country is not dependent on foreign sources of supply during war.

**QUESTION: 26**

Which of the following provides the best justification for reducing trade barriers among nations?

- A. The military self-sufficiency argument.
- B. Diversification for stability argument.
- C. The infant industry argument.
- D. Increased total world output argument.

**Answer : D**

The general effect of free trade would be to maximize world output because resources in each country would be deployed most efficiently according to the principle of comparative advantage. Comparative advantage means that a country can produce a greater output of certain goods for a given level of input than other goods. Thus, that country should specialize in and export the goods it can produce most efficiently. Total world output will increase in these circumstances.

**QUESTION: 27**

If a country uses trade quotas to overcome chronic trade deficits, what would the most likely outcome be?

- A. Unemployment and productivity rates will rise.
- B. Unemployment rates will rise and productivity rates will decline.
- C. Unemployment rates will decline and productivity rates will rise.
- D. Unemployment and productivity rates will decline.

**Answer : D**

With trade quotas, home jobs will be saved, hence, unemployment will decline. Since jobs will be saved for inefficient industries less efficient than foreign competitors), productivity rates will decline because they will not be specializing in those goods with which they have a comparative advantage.

**QUESTION: 28**

What are revenue tariffs designed to do?

- A. Develop new export opportunities.
- B. Provide the government with tax revenues.
- C. Restrict the amount of a commodity that can be imported in a given period.

D. Encourage foreign companies to limit the amount of their exports to a particular country.

**Answer : B**

Revenue tariffs are usually applied to products that are not produced domestically. Their purpose is to provide the government with tax revenue.

**QUESTION: 29**

Governments most likely restrict trade in the long run to

- I. Help foster new industries.
- II. Protect declining industries.
- III. Increase tax revenues.
- IV. Foster national security.

- A. I only.
- B. I and II only.
- C. II and III only
- D. I, II, and IV only

**Answer : B**

Governmental impediments to global competition are generally imposed for the announced purpose of protecting local entities and jobs and developing new industries. They also may have the effect of raising revenue in the short run. In the long run, tax and revenues will decline because of reduced trade. Examples of governmental impediments are tariffs; duties; quotas; domestic content rules; preferences for local entities regarding procurement, taxes, R&D, labor regulations, and other operating rules; and laws e.g., anti-bribery or tax) enacted by a national government that impede national entities from competing globally. These impediments are most likely when industries are viewed as crucial.

**QUESTION: 30**

When a multinational entity decides to sell its products abroad, one of the risks it faces is that the government of the foreign market charges the entity with dumping. Dumping occurs when

- A. The same product sells at different prices in different countries.
- B. An entity charges less than it costs to make the product to enter or win a market.
- C. Lower quality versions of the product are sold abroad so as to be affordable.
- D. Transfer prices are set artificially high so as to minimize tax payments.

**Answer : B**

Dumping is an unfair trade practice that violates international agreements. It occurs when an entity charges a price 1) lower than that in its home market or 2) less than the cost to make the product. Dumping may be done to penetrate a market or as a result of export subsidies.

**QUESTION: 31**

Which of the following statements is true with respect to international transfer pricing?

- A. Transfer prices charged to foreign subsidiaries must be the same as those charged to domestic subsidiaries.

- B. The existence of tariffs in the foreign country may necessitate that a higher transfer price be charged a foreign subsidiary.
- C. Limitations on taking profits out of a foreign country can be avoided by charging the foreign subsidiary a higher transfer price.
- D. Currency restrictions prohibit payments to foreign vendors.

Answer : C

Transfer pricing is an important aspect of the tax calculation for multinational corporations that transfer inventories between branches in different countries. Transfer prices charged to foreign subsidiaries may differ substantially from those charged to domestic subsidiaries for a variety of reasons. Limitations on taking profits out of a foreign country can be avoided by charging the foreign subsidiary a higher transfer price so that little or no profit exists to be repatriated.

QUESTION: 32

An entity produces a T I I d in country A and sells some of its output in country B. Selling prices are identical in the two countries. The corporate tax rates are 40% in country A and 20% in country B. Assuming that the entity does not increase or decrease production, it should <List A> sales in country B and set as <List B> a transfer price as possible, in order to minimize global taxes.

	List A	List B
A.	Maximize	High
B.	Maximize	Low
C.	Minimize	High
D.	Minimize	Low

Answer : B

The tax-minimizing strategy is to minimize taxable income where tax rates are high and to maximize taxable income where tax rates are low. Consequently, the entity should sell more in country B but set a low transfer price. This dual strategy minimizes sales and profits in country A, minimizes cost of sales in country B. and maximizes sales and profits in country B.

QUESTION: 33

An individual had taxable income of US \$23,r\_ir\_ir' per year and paid US \$8,000 in income tax. The individual's taxable income then increased to US \$30,000 per year resulting in a US \$10,000 income tax liability. The personal tax system being applied to this individual is

- A. Progressive.
- B. Regressive.
- C. Marginal.
- D. Proportional.

Answer : B

The average t rate of the individual has decreased from 34.8% US \$8,000 - \$23,000) to 33.3% (US \$10.000 Under a regressive tax system, the average tax rate falls as income rises, although the amount of tax paid may rise.

QUESTION: 34

In most countries <List A> taxes tend to be <List B> with respect to income

	List A	List B
A.	General sales	Proportional
B.	Property	Regressive
C.	Personal income	Proportional
D.	Personal income	Regressive

**Answer : B**

Property taxes tend to be regressive. Taxpayers with lower incomes must pay a higher portion of their incomes for necessities, such as housing.

**QUESTION: 35**

In a <List A> personal tax system, an individual's marginal tax rate is normally <List B> the average tax rate.

	List A	List B
A.	Progressive	Greater than
B.	Progressive	Equal to
C.	Regressive	Equal to
D.	Regressive	Greater than

**Answer : A**

The marginal tax rate is the tax applicable to the last unit of income, whereas the average tax rate is the total tax paid divided by taxable income. In a progressive tax system, higher incomes attract higher tax rates, so the marginal tax rate paid on the last unit of income exceeds the average tax rate.

**QUESTION: 36**

On what basis is value-added tax collected?

- A. The difference between the value of an entity's sales and the value of its purchases from other domestic entities.
- B. The difference between the selling price of a real estate property and the amount the entity originally paid for the property.
- C. The value of an entity's sales to related companies.
- D. The profit earned on an entity's sales.

**Answer : A**

A value-added tax (VAT) is collected on the basis of the value created by the entity. This tax is measured by the difference between the value of the entity's sales and the value of its purchases. A VAT is in effect a retail sales tax. Because a consumer can avoid the tax by not purchasing, a VAT encourages saving and discourages consumption.

**QUESTION: 37**

To index a progressive tax system to inflation, the government must

- A. Adjust only tax deductions and exemptions.

- B. Adjust only tax brackets.
- C Adjust deductions, exemptions, and tax brackets.
- D Ensure that nominal tax receipts grow more slowly than inflation.

**Answer : C**

If tax brackets are not adjusted for inflation, increases in nominal but not real income may push taxpayers into tax brackets with higher progressive) rates. Additionally, deductions and exemptions must be indexed so that the real incidence of taxation is not increased by inflation. Increases in nominal but not real income will result in higher real taxable income if deductions and exemptions have not been adjusted for inflation.

**QUESTION: 38**

An entity purchases US \$150,000 of inputs from other entities and incurs US \$500,000 of labor costs in manufacturing its products. It also incurs US \$100,000 of interest expense. The entity sells all of its output for US \$2.5 million. Rather than paying income tax, the entity must pay a 25% value-added tax. How much tax will be due for this year's activities?

- A. US \$437,500
- B. US \$462,500
- C. US \$587,500
- D. US \$625,000

**Answer : C**

The value added is the difference between the value of the output and the value of the purchased inputs. Value-added tax payable equals the value-added tax rate times value added, or US \$587,500  $[(\$2,500,000 - \$150,000) \times .25]$ .

**QUESTION: 39**

Which of the following designations refers to taxes that will not necessarily take a larger absolute amount of income as income rises?

- A. Progressive.
- B. Proportional.
- C. Regressive
- D. Regenerative

**Answer : C**

Regressive taxes are those for which the average tax rate falls as income rises. They take a smaller percentage of income as income rises, so they will not necessarily take a larger absolute amount of income as income rises.

**QUESTION: 40**

A taxpayer who earns US \$50,000 during the year and pays a 15% tax rate on the first US \$30,000 of income and a 30% tax rate on all earnings over US \$30,000 has a(n)

- A. Marginal tax rate of 15%.
- B. Marginal tax rate of 21%.
- C. Average tax rate of 21%.
- D. Average tax rate of 22.5%.

**Answer : C**

The average tax rate is calculated using the weighted-average method. The weight assigned to each rate is determined by the proportion of taxable income subject to it. The average tax rate is 21% [(US \$30,000 \$50,000) x .15 + \$20,000 \$50,000) x .30].

**QUESTION: 41**

A tax is regressive if

- A. Individuals with higher incomes pay a higher percentage of their income in tax.
- B. The burden for payment falls disproportionately on lower-income persons.
- C. Individuals pay a constant percentage in taxes, regardless of income level.
- D. Individuals with lower incomes pay a lower percentage of their income in tax.

**Answer : B**

With a regressive tax, the percentage paid in taxes decreases as income increases. For example, excise taxes and payroll taxes are both regressive taxes. An excise tax is regressive because its burden falls disproportionately on lower-income persons. As personal income increases, percentage of income paid declines because an excise tax is a flat amount per quantity of the good or service purchased.

**QUESTION: 42**

General sales taxes tend to be regressive with respect to income because

- A. A larger portion of a lower income person's income is subject to the tax.
- B. A smaller portion of a lower income person's income is subject to the tax.
- C. The tax rate is higher for person with lower income.
- D. The tax claims an increasing amount of income as income rises.

**Answer : A**

A sales tax is regressive with respect to income even though the rate is the same regardless of the buyer's income. The reason is that a greater percentage of a low-income individual's income is exposed to the tax. A higher-income individual should be able to save more and therefore shield a greater percentage of his/her income from the tax.

**QUESTION: 43**

Under a value-added taxing system

- A Businesses must pay a tax only if they make a profit
- B The consumer ultimately bears the incidence of the tax through higher prices.
- C Consumer savings are discouraged.
- D. The amount of value added is the difference between an entity's sales and its cost of goods sold.

**Answer : B**

A value-added tax is based on consumption. The tax is levied on the value added to goods by each business unit in the production and distribution chain. It is the consumer who ultimately bears the incidence of the tax because businesses subject to the tax will raise prices to offset the operating cost of the tax.

**QUESTION: 44**

A nation has a progressive tax structure with income tax brackets that are not indexed to inflation. An individual taxpayer experiences an income increase just equal to the general inflation rate and moves into a higher tax bracket. The individual taxpayer will then experience -List A- nominal taxes payable and- List B- real taxes payable.

	List A	List B
A.	Increasing	Increasing
B.	Increasing	Decreasing
C.	Decreasing	Increasing
D.	Decreasing	Decreasing

**Answer : A**

Because the taxpayer's income increase equal to the general inflation rate, no real increase in income has occurred. However, some or all of the increase is subject to a higher tax rate. Accordingly the taxpayer will experience an increase in both nominal taxes payable and in real taxes payable.

**QUESTION: 45**

A value-added tax is collected on the basis of

- A. The difference between the value of an entity's sales and the value of its purchases from other domestic entities.
- B. The difference between the selling price of a real estate property and the amount the entity originally paid for it.
- C. The value of an entity's sales to related companies.
- D. The profit earned on an entity's sales.

**Answer : A**

A value-added tax is similar to a retail sales tax on consumer goods. It is applied to the difference between the value of an entity's sales and the value of its purchases from other entities, that is. to the value added to the input. In effect, a value-added tax is a national tax that penalizes consumption.

**QUESTION: 46**

An entity in a 40% tax bracket needs <List A> of operating income to pay 1 of interest and <List B> of pretax income to pay 1 of dividends.

	List A	List B
A.	.60	.60
B.	1.00	1.00
C.	1.00	1.67
D.	1.67	1.00

**Answer : C**

Interest is deductible from operating income to obtain taxable income but dividends are not. Thus, only 1.00 of pretax income is needed to pay 1.00 of interest, but 1.67 of pretax income  $[1.00 - 1.0 - .4]$  is needed to pay 1.00 of dividends if the entity is in a 40% tax bracket.

**QUESTION: 47**

Value-added taxes are levied on

- A. Interest income received by individual owners of publicly traded bonds.
- B. Dividend income received by corporations owning shares of other corporations
- C. The value of an entity's assets.
- D. The difference between an entity's sales and its purchases from other entities.

**Answer : D**

A value-added tax is levied on the value an entity adds to a good or service. This amount is measured as the difference between the value of an entity's sales and the value of its purchases from other entities. A value-added tax is therefore similar to a retail sales tax. It is equivalent to a national sales tax on consumer goods. By penalizing consumption, it encourages saving and investment.

**QUESTION: 48**

An increase in excise taxes will generate <List A- tax revenue if it is levied on products for which demand is <List B> elastic.

	List A	List B
A.	More	More
B.	More	Less
C.	Negative	Less
D.	Less	Less

**Answer : B**

A higher excise tax increases the selling price of the product. This price increase will have a less negative effect on sales volume for products with less elastic demand. Examples of products with low elasticity of demand include gasoline, tobacco, and alcohol. The tax revenue generated by an increase in excise taxes is therefore higher if the taxes are levied on products with less elastic demand.

**QUESTION: 49**

Which of the following correctly describes the introduction of a government tax credit on investments?

- A. Corporate investments will have higher net present values, all else equal, than without the tax credit.
- B. Tax credits on investments are designed to restrain inflation.
- C. Tax credits on investments increase investment costs, and all else equal, reduce the level of corporate investment.
- D. Tax credits on investments are taxes that are typically levied on individual projects rather than on groups of projects.

**Answer : A**

An investment tax credit is an incentive because it directly reduces future tax payments. Thus, corporate investments will have higher net present values, all else equal, than without tax credits.

**QUESTION: 50**

Which of the following refers to taxes that do not necessarily take a larger absolute share of an increase in income?



- A. Progressive.
- B. Proportional
- C. Regressive.
- D. Flat.

**Answer : C**

Regressive taxes are those for which the average tax rate falls as income rises. They take a smaller percentage of income as income rises, so they will not necessarily take a larger absolute amount of income as income rises.

**QUESTION: 51**

The trough of a business cycle is generally characterized by

- A. Shortages of essential raw materials and rising costs.
- B. Increasing purchasing power and increasing capital investments.
- C. Rising costs and an unwillingness to risk new investments.
- D. Unused productive capacity and an unwillingness to risk new investments.

**Answer : D**

There are four phases of a business cycle: trough, recovery, peak, and recession. The trough is marked by low levels of economic activity and underuse of resources. Investors are unwilling to risk new investments in productive capacity.

**QUESTION: 52**

During the recessionary phase of a business cycle,

- A. The purchasing power of money is likely to decline rapidly.
- B. The natural rate of unemployment will increase dramatically.
- C. Potential national income will exceed actual national income
- D. Actual national income will exceed potential national income.

**Answer : C**

There are four phases of a business cycle: trough, recovery, peak, and recession. During the recessionary phase of a business cycle, economic activities and employment levels contract and society's resources are underused. Because of the underuse of resources, potential national income will exceed actual national income.

**QUESTION: 53**

Which of the following may provide a leading indicator of a future increase in gross domestic product?

- A. A reduction in the money supply.
- B. A decrease in the issuance of building permits.
- C. An increase in the timeliness of delivery by vendors.
- D. An increase in the average hours worked per week of production workers.

**Answer : D**

An economic indicator is highly correlated with changes in aggregate economic activity. A leading indicator changes prior to a change in the direction of the business cycle. The leading indicators included in the Conference Board's index are average weekly hours

worked by manufacturing workers, unemployment claims, consumer goods orders, stock prices, orders for fixed assets, building permits, timeliness of deliveries, money supply, consumer confidence, and the spread between the yield on 10-year Treasury bonds and the federal funds rate. An increase in weekly hours worked by production workers is favorable for economic growth.

**QUESTION: 54**

Some economic indicators lead the economy into a recovery or recession, and some lag it. An example of a lag variable is

- A. Chronic unemployment.
- B. Orders for consumer and producer goods.
- C. Housing starts.
- D. Consumer expectations.

**Answer : A**

Economists use a variety of economic indicators to forecast turns in the business cycle. Economic indicators are variables that in the past have had a high correlation with aggregate economic activity. The best known are the composite indexes calculated by The Conference Board, a private research group with more than 2,700 corporate and other members worldwide. Indicators may lead, lag, or coincide with economic activity. The Conference Board's lagging indicators include average duration of unemployment in weeks, the change in the index of labor cost per unit of output, the average prime rate charged by banks, the ratio of manufacturing and trade inventories to sales, the commercial and industrial loans outstanding, the ratio of consumer installment credit outstanding to personal income, and the change in the CPI for services.

**QUESTION: 55**

All of the following are stages of the business cycle except

- A. Boom, or peak.
- B. Trough.
- C. Recovery.
- D. Acceleration.

**Answer : D**

A business cycle has four stages: the trough, recovery, peak, and recession. Acceleration is not one of the stages.

**QUESTION: 56**

The two main variables that contribute to increases in real gross domestic product (GDP) derived from labor inputs are labor productivity and

- A. The potential labor force.
- B. The inflation rate.
- C. Quality of output.
- D. Total worker hours.

**Answer : D**

Real GDP increases when resource inputs and their productivity increase. Thus, to the extent that real GDP depends on labor inputs, real GDP equals total worker hours labor input) times labor productivity real output per worker per hour).

**QUESTION: 57**

If the government of a country uses its foreign currency reserves to <List A> its own currency in the foreign currency market, the effect is to <List B> domestic aggregate demand.

	List A	List B
A.	Purchase	Not affect
B.	Purchase	Decrease
C.	Sell	Not affect
D.	Sell	Decrease

**Answer : B**

Aggregate demand is the amount of real domestic output that domestic consumers, foreign buyers, governments, and businesses will want to purchase at each price level. One factor that changes aggregate demand is net export spending. Exchange rates are among the determinants of net export spending. When a government intervenes in the foreign currency market to purchase its own currency, it causes an appreciation of that currency. One result is that the trade balance will be affected. Exports will fall as domestic goods become more costly from the perspective of foreign consumers. Imports will rise as foreign goods become less costly for domestic consumers. Consequently, net exports will decline and domestic aggregate demand will also decline.

**QUESTION: 58**

The sale of final goods is <List A> the gross domestic product, and the sale of intermediate goods is <List B> the gross domestic product.

	List A	List B
A.	Included in	Included in
B.	Included in	Excluded from
C.	Excluded from	Included in
D.	Excluded from	Excluded from

**Answer : B**

The sale of final goods is included in, and the sale of intermediate goods is excluded from, GDP. The purpose of this treatment is to avoid double counting. The value of final goods already includes any intermediate transactions involved in their production.

**QUESTION: 59**

Under the income approach, gross domestic product (GDP) is measured as

- A. Depreciation charges and indirect business taxes + Wages + Rents + Interest + Profits adjusted for net income earned abroad.
- B. Wages + Rents + interest + Profits.
- C. Depreciation charges and indirect business taxes + Wages + Rents - Interest + Profits.
- D. Wages + Rents + interest - Profits adjusted for net income earned abroad.

**Answer : A**

GDP is the total value of goods and services produced within the boundaries of a country. It may be measured using an expenditures approach or an income approach. Under the income approach, GDP equals all income derived from the production of the year's output, with an adjustment for net income earned abroad a positive or negative amount in theory).

Two types of nonincome charges or allocations must be added to incomes (wages, rents, interest, and profits). Depreciation reflects the consumption of fixed capital during the period. It is the part of the year's receipts that must be allocated to replace the machinery, plant, etc. used up in the production of GDP. Indirect business taxes, such as sales, excise, and property taxes, are treated by businesses as a cost of production and form part of the total price of goods and services. Thus, they are not paid as wages, rents, interest, and profits. Accordingly, GDP may be measured as the sum of consumption of fixed capital, indirect business taxes, wages, rents, interest, and profits (proprietors' income, corporate taxes, dividends, and undistributed corporate profits), with an adjustment for net income earned abroad.

**QUESTION: 60**

Net domestic product is composed of the total market value of all

- A. Final goods and services produced in the economy in 1 year.
- B. Goods and services produced in the economy in 1 year.
- C. Final goods and services produced in the economy in 1 year minus the capital consumption allowance.
- D. Goods and services produced in the economy in 1 year minus the capital consumption allowance.

**Answer : C**

Net domestic product is the market value of all final goods and services produced within the boundaries of a country within 1 year minus the capital consumption allowance.

**QUESTION: 61**

The gross domestic product (GDP) does not measure:

- A. National economic performance.
- B. Market-oriented activity.
- C. Improvements in product quality.
- D. The size of national output.

**Answer : C**

GDP is the total market value of all final goods and services produced within the boundaries of the U.S. in one year, without regard to ownership of the means of production. It is a monetary measure of quantitative data, not qualitative characteristics. Thus, improvements in product quality are not measured by GDP.

**QUESTION: 62**

The gross domestic product (GDP) will fall following an increase in

- A. Consumption expenditures.
- B. Imports.
- C. Exports.
- D. Inflation.

**Answer : B**

By definition, GDP determined using the expenditures approach equals the sum of consumption, investment, government purchases of goods and services, and net exports (exports - imports). Thus, a rise in imports will cause a fall in net exports and GDP.

**QUESTION: 63**

Under the "output" approach, gross domestic product (GDP) is measured as

- A. Non-income charges or allocations + wages + rents + interest.
- B. Non-income charges or allocations + wages + rents + interest + profits.
- C. Consumption expenditures + investment + government purchases + interest
- D. Consumption expenditures + investment + government purchases + expenditures by foreigners.

**Answer : D**

GDP is the total value of all goods and services produced in the U.S., regardless of the ownership of the means of production. GDP can be measured using an income or output (expenditures) approach. The output approach measures the amount spent to purchase the year's total output. Using this approach, GDP is calculated by adding consumption expenditures by households, investment expenditures by businesses, government purchases of goods and services, and expenditures by foreigners.

**QUESTION: 64**

In the output or "expenditures" approach to measuring a country's gross domestic product, which of the following calculations is used?

- A. Consumption + Investment + Government purchases + Expenditures by foreigners.
- B. Consumption + Investment + Government purchases - Expenditures by foreigners.
- C. Consumption + Investment - Government purchases - Expenditures by foreigners
- D. Consumption + Investment - Government purchases - Expenditures by foreigners

**Answer : A**

GDP can be calculated using an income approach or an expenditures approach because what is spent on a product or service is income to those who contributed resources to its production and marketing. Thus, the amount spent to purchase the GDP is identical with the income derived from its production and sale. Under the output or expenditures approach, GDP equals the sum of consumption expenditures by households, investment by business, government purchases of goods and services, and expenditures by foreigners (net exports).

**QUESTION: 65**

A contract dispute has arisen between an organization and a major supplier. To resolve the dispute, the most competent evidence is

- A. Oral testimony of contracting parties.
- B. The original contract.
- C. Actions by parties to the contract.
- D. A letter from the supplier's attorney.

**Answer : B**

The best primary evidence is the most persuasive evidence. Reliability and the best evidence rule are closely related. The best evidence rule is ordinarily applied only to documentary evidence, especially to proof of the content of a writing. If the original writing is available, the best evidence rule prohibits a party from proving the content of a writing through oral testimony. Therefore, the original writing is the most competent

evidence.

**QUESTION: 66**

Which of the following statements describes an internal control questionnaire? It

- A. Provides detailed evidence regarding the substance of the control system.
- B. Takes less of the engagement client's time to complete than other control evaluation devices.
- C. Requires that the internal auditor be in attendance to properly administer it.
- D. Provides indirect evidence that might need corroboration.

**Answer : D**

An internal control quest consists re consists of a series of questions about the controls designed to prevent or detect errors or irregularities lies. Answers to the questions help the internal auditor to identify specific internal control policies and procedures relevant to specific assertions and to design tests of controls to evaluate the effectiveness of their design and operation. The questionnaire provides a framework to assure that specific concerns are not overlooked. but it is not a sufficient means of understanding the entire system. Thus, the evidence obtained is indirect and requires corroboration by means of observation. interviews, flowcharting. examination of documents, etc.

**QUESTION: 67**

During interviews with the inventory management personnel. an internal auditor learned that salespersons often order inventory for stock without receiving the approval of the vice president of sales\_ Also, detail testing showed that there are no written approvals on purchase orders for replacement parts. The detail testing is a good example of

- A. Indirect evidence.
- B. Circumstantial evidence.
- C. Corroborative evidence.
- D. Subjective evidence.

**Answer : C**

Corroborative evidence is evidence from a different source that supplements and confirms other evidence. For example, oral testimony that a certain procedure was not performed may be corroborated by the absence of documentation.

**QUESTION: 68**

Much of the internal auditor's work involves accumulation of engagement information. A duplicate of a contract rather than the original is an example of what kind of evidence?

- A. Secondary.
- B. Circumstantial.
- C. Hearsay.
- D. Opinion.

**Answer : A**

Secondary evidence according to the legal view is acceptable if primary evidence the strongest evidence, e.g., original documents) has been destroyed or is not reasonably procurable. Secondary evidence must be a proper representation of primary evidence, e.g., copies of a contract.

**QUESTION: 69**

Which of the following is not a required element of a contract?

- A. Legality.
- B. Consideration.
- C. Legal capacity.
- D. A writing.

**Answer : D**

The four essential elements of a contract are an agreement offer and acceptance), consideration, legal capacity of the parties to contract, and a legal objective or purpose A writing is not required to enter into a contract. However, some contracts are not enforceable unless a writing evidences the contract

**QUESTION: 70**

The necessary elements of a contract include

- A. Some form of writing, equal consideration, and legal capacity.
- B. Formal execution, definite terms, and a valid offer and acceptance.
- C. Offer and acceptance, consideration, legal capacity, and mutual assent.
- D. Bilateral promises, legal capacity, and legality of purpose.

**Answer : C**

Contracts require each of the following:

1. Offer and acceptance
2. Mutual assent meeting of the minds)
3. Consideration bargained-for exchange)
4. Legality legal purpose)
5. Capacity of parties legal ability)

**QUESTION: 71**

Consideration consists of

- A. Something with monetary value\_
- B. Each party's receiving an actual benefit only.
- C. Two promises.
- D. Legal sufficiency and bargained-for exchange.

**Answer : D**

Consideration must be legally sufficient and intended as a bargained-for exchange. A promisee has provided legally sufficient consideration if s)he incurs a legal detriment or if the promisor receives a legal benefit An essential aspect of consideration is that it be bargained for, and given in exchange for, the consideration provided by the other party\_ That is, consideration is mutual.

**QUESTION: 72**

Lamar became homeless at a very young age and was taken in by Aunt and Uncle. Many years later, Lamar became a detective in the city police department. When Aunt disappeared and was not heard from for a month, the case was assigned to Lamar. Uncle also came to Lamar and asked him to promise to find Aunt in return for the years of



support. Lamar agreed to Uncle's request. Which of the following is true?

- A. Lamar's contractual duty to find Aunt is based on past consideration.
- B. Lamar has no contractual duty to find Aunt.
- C. If Uncle had also promised Lamar US \$1,000 for finding Aunt, he would be liable when Lamar found her.
- D. Lamar will be liable for breach of contract if he does not find Aunt.

**Answer : B**

Lamar has a pre-existing legal duty to find Aunt. Consideration does not exist if an existing duty was imposed by law or a person is already under a contractual agreement to render a specified performance. Lamar will suffer no new legal detriment by finding Aunt; thus, no contractual obligation exists.

**QUESTION: 73**

Which of the following creates a valid contract between the parties?

- A. A reward was posted for the capture of Tom Jones\_ Maypole Burden, the county sheriff, captured Jones and claimed the reward.
- B. Slim Polestone promised to give Mabel Abbot a wedding present.
- C. Anxious Father promised to pay Albert Niceguy US \$4,000 to take his daughter to the annual Mulestone Dance. Albert agreed.
- D. Festival Fanny was drowning in her hot tub. Her boyfriend pulled her out. After the rescue, Festival's husband promised to pay her boyfriend US \$4 for rescuing his wife.

**Answer : C**

A valid contract exists because Anxious Father offered to pay Albert US \$4,000 for taking his daughter to the dance. This is a unilateral contract supported by the consideration of US \$4,000. Albert will be entitled to the US \$4,000 after he takes the daughter to the dance.

**Section 1: Sec One (74 to 185)**

**Details: Managerial Accounting**

**QUESTION: 74**

Control objectives regarding effectiveness and efficiency, reliability, and compliance are the basis of which control framework?

- A. GTAG.
- B. eSAC.
- C. COBIT.
- D. COSO.

**Answer: D**

Probably the most well-known control framework in the U.S. is Internal Control Integrated Framework, published in 1992 by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The document is commonly referred to as the COSO Framework." The COSO Framework defines internal control as A process, effected by an organization's board of directors, management, and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

- Effectiveness and efficiency of operations



- Reliability of financial reporting
- Compliance with applicable laws and regulations

**QUESTION: 75**

Which of the following control frameworks was acknowledged by the U.S. Securities and Exchange Commission as an appropriate model for designing internal controls under the requirements of the Sarbanes-Oxley Act of 2002?

- A. COSO.
- B. eSAC.
- C. COBIT.
- D. GTAG.

**Answer: A**

The importance and durability of the COSO Framework was reinforced when the U.S. Securities and Exchange Commission acknowledged it as an appropriate model for designing internal controls under the requirements of the Sarbanes-Oxley Act of 2002.

**QUESTION: 76**

Which of the following control frameworks groups IT business assurance objectives into the five categories of availability, capability, functionality, protectibility, and accountability?

- A. COBIT.
- B. COSO.
- C. eSAC.
- D. GTAG.

**Answer: C**

eSAC's IT business assurance objectives fall into these five categories: availability, capability, functionality, protectibility, and accountability.

**QUESTION: 77**

Which of the following types of controls is not described in the IT Governance Institute's Control Objectives for information and Related Technology (COBIT)?

- A. General controls.
- B. Exchange controls.
- C. Business controls.
- D. Process controls.

**Answer: B**

COBIT describes controls in three areas: process controls, business controls, and IT general and application controls.

**QUESTION: 78**

Which of the following "families" of controls is not described in The IIA's Global Technology Audit Guide (GTAG) 1, titled information Technology Controls?

- A. Governance, management, and technical controls.
- B. Preventive, detective, and corrective controls.
- C. Feedback, concurrent, and feedforward controls.
- D. IT general and application controls.

**Answer:** C

Feedback, concurrent, and feedforward controls are not referenced in GTAG 1.

**QUESTION:** 79

According to eSAC, accountability is

- A. Usually an issue with regard to trade secrets and other intellectual property.
- B. The control attribute that identifies the source of a transaction.
- C. The restriction of access to processing and storage devices.
- D. Most often applicable to personal information about employees and customers.

**Answer:** B

Accountability is the control attribute that identifies the source of a transaction. It specifies employees' roles, actions, and responsibilities. Thus, the person who caused a transaction is identifiable. Fundamental concepts of accountability are data ownership, identification, and authentication.

**QUESTION:** 80

COBIT is

- A. A set of guidelines to assist in implementing adequate controls over IT processes.
- B. A set of risks and responses to technology challenges.
- C. The update of the previous Systems Auditability and Control reports.
- D. Published by the Committee of Sponsoring Organizations.

**Answer:** A

COBIT (Control Objectives for Information and related Technology) is an IT control framework copyrighted by the IT Governance Institute (ITGI). COBIT is a set of guidelines to assist management and business process owners in implementing adequate controls over IT processes and resources. It is designed to be an IT governance tool that facilitates understanding and managing the risks and benefits associated with information and related IT.

**QUESTION:** 81

COBIT is targeted at all of the following except

- A. Management.
- B. Users.
- C. Shareholders.
- D. Auditors.

**Answer:** C

COBIT is targeted at three distinct audiences: management, users, and auditors. Management must balance risks and control costs in the volatile IT environment. Users need assurance about the security of, and controls over, internal or third-party IT services.

Auditors must be able to support their opinions conveyed to management and others about the state of internal control. Because shareholders are not directly involved with IT services used in the day-to-day management of an organization, they are not a targeted audience of COBIT.

**QUESTION: 82**

Which of the following statements accurately describes the impact that automation has on the controls normally present in a manual system?

- A. Transaction trails are more extensive in a computer-based system than in a manual system because there is always a one-for-one correspondence between data entry and output.
- B. Responsibility for custody of information assets is more concentrated in user departments in a computer-based system than it is in a manual system.
- C. Controls must be more explicit in a computer-based system because many processing points that present opportunities for human judgment in a manual system are eliminated.
- D. The quality of documentation becomes less critical in a computer-based system than it is in a manual system because data records are stored in machine-readable files.

**Answer: C**

Using a computer does not change the basic concepts and objectives of control. However, the use of computers may modify the control techniques used. The processing of transactions may be combined with control activities previously performed separately, or control function may be combined within the information system activity.

**QUESTION: 83**

Which of the following characteristics distinguishes computer processing from manual processing?

- A. Computer processing virtually eliminates the occurrence of computational error normally associated with manual processing.
- B. Errors or fraud in computer processing will be detected soon after their occurrence.
- C. The potential for systematic errors is ordinarily greater in manual processing than in computerized processing.
- D. Most computer systems are designed so that transaction trails useful for audit purposes do not exist.

**Answer: A**

Computer processing uniformly subjects like transactions to the same processing instructions. A computer program defines the processing steps to accomplish a task. Once the program is written and tested appropriately, it will perform the task repetitively and without error. However, if the program contains an error, all transactions will be processed incorrectly.

**QUESTION: 84**

A firm has recently converted its purchasing cycle from a manual process to an online computer system. Which of the following is a probable result associated with conversion to the new automatic system?

- A. Processing errors are increased.
- B. The firm's risk exposures are reduced.
- C. Processing time is increased.

D. Traditional duties are less segregated.

**Answer: D**

In a manual system with appropriate internal control, separate individuals are responsible for authorizing transactions, recording transactions, and custody of assets. These checks and balances prevent fraud and detect inaccurate or incomplete transactions. In a computer environment, however, this segregation of duties is not always feasible. For example, a computer may print checks, record disbursements, and generate information for reconciling the account balance.

**QUESTION: 85**

A small client recently put its cash disbursements system on a server. About which of the following internal control features would an auditor most likely be concerned?

- A. Programming of the applications are in Visual Basic rather than Java.
- B. The server is operated by employees who have cash custody responsibilities.
- C. Only one employee has the password to gain access to the cash disbursement system.
- D. There are restrictions on the amount of data that can be stored and on the length of time that data can be stored

**Answer: B**

Segregation of duties is a basic category of control activities AU 319). Functions are incompatible if a person is in a position both to perpetrate and conceal fraud or errors. Hence, the duties of authorizing transactions, recording transactions, and custody of assets should be assigned to different people. Those employees that operate the server may be able to override the controls to change records to conceal a theft of cash.

**QUESTION: 86**

Which of the following statements most likely represents a disadvantage for an entity that keeps data files on a server rather than on a manual system?

- A. Attention is focused on the accuracy of the programming process rather than errors in individual transactions.
- B. It is usually easier for unauthorized persons to access and alter the files.
- C. Random error associated with processing similar transactions in different ways is usually greater.
- D. It is usually more difficult to compare recorded accountability with the physical count of assets.

**Answer: B**

In a manual system, one individual is usually assigned responsibility for maintaining and safeguarding the records. However, in a server environment, the data files may be subject to change by others without documentation or an indication of who made the changes.

**QUESTION: 87**

A small company has changed from a system of recording time worked on clock cards to a computerized payroll system in which employees record time in and out with magnetic cards. The computer system automatically updates all payroll records. Because of this change,

- A. A generalized computer audit program must be used.

- B. Part of the audit trail is altered.
- C. The potential for payroll-related fraud is diminished.
- D Transactions must be processed in batches.

**Answer: B**

In a manual payroll system, a paper trail of documents is created to provide audit evidence that controls over each step in processing are in place and functioning. One element of a computer system that differentiates it from a manual system is that a transaction trail useful for auditing purposes might exist only for a brief time or only in computer-readable form.

**QUESTION: 88**

Batch processing

- A. Is not used by most businesses because it reduces the audit trail.
- B. Allows users to inquire about groups of information contained in the system.
- C. Accumulates transaction records into groups for processing against the master file on a delayed basis.
- D Can only be performed on a centralized basis.

**Answer: C**

Batch processing is the accumulation and grouping of transactions for processing on a delayed basis. The batch approach is suitable for applications that can be processed against the master file at intervals and involve large volumes of similar items, such as payroll, sales, inventory, and billing.

**QUESTION: 89**

What type of computer processing system is characterized by data that are assembled from more than one location and records that are updated immediately?

- A. Personal computer systems.
- B. Data compression systems.
- C. Batch processing systems.
- D. Online, real-time systems.

**Answer: D**

Real-time processing involves processing an input record and receiving the output soon enough to affect a current decision-making process. In a real-time system, the user interacts with the system to control an ongoing activity. Online indicates that the decision maker is in direct communication with the computer. Online, real-time systems usually permit access to the main computer from multiple remote terminals.

**QUESTION: 90**

Misstatements in a batch computer system caused by incorrect programs or data may not be detected immediately because

- A. Errors in some transactions may cause rejection of other transactions in the batch.
- B. The identification of errors in input data typically is not part of the program.
- C. There are time delays in processing transactions in a batch system.
- D The processing of transactions in a batch system is not uniform.

**Answer: C**

Transactions in a batch computer system are grouped together, or batched, prior to processing. Batches may be processed either daily, weekly, or even monthly. Thus, considerable time may elapse between the initiation of the transaction and the discovery of an error.

**QUESTION: 91**

The two broad groupings of information systems control activities are general controls and application controls. General controls include controls

- A. Relating to the correction and resubmission of faulty data.
- B. For developing, modifying, and maintaining computer programs.
- C. Designed to assure that only authorized users receive output from processing.
- D. Designed to ensure that all data submitted for processing have been properly authorized.

**Answer: B**

General controls are policies and procedures that relate to many information systems application and support the effective functioning of application controls by helping to ensure the continued proper operation of information systems. General controls include controls over 1) data center and network operations; 2) systems software acquisition and maintenance; 3) access security; and 4) application systems acquisition, development, and maintenance AU 319).

**QUESTION: 92**

The purpose of input controls is to ensure the

- A. Authorization of access to data files.
- B. Authorization of access to program files.
- C. Completeness, accuracy, and validity of updating.
- D. Completeness, accuracy, and validity of input.

**Answer: D**

Input controls provide reasonable assurance that data received for computer processing have been properly authorized and are in a form suitable for processing, i.e., complete, accurate, and valid. Input controls also relate to rejection, correction, and resubmission of data that were initially incorrect.

**QUESTION: 93**

A mail-order retailer of low-cost novelty items is receiving an increasing number of complaints from customers about the wrong merchandise being shipped. The order code for items has the format The major category is ww, xx is the minor category, yy identifies the item, and zz identifies the catalog. In many cases, the wrong merchandise was sent because adjacent characters in the order code had been transposed. The best control for decreasing the number of orders with the wrong merchandise is to

- A. Require customers to specify the name for each item they order.
- B. Add check-digits to the order codes and verify them for each order.
- C. Separate the parts of the order code with hyphens to make the characters easier to read.
- D. Use a master file reference for all order codes to verify the existence of items.

**Answer: B**

Self-checking digits may be used to detect incorrect codes. The digit is generated by applying an algorithm to the code. During the input process, the check digit is recomputed by applying the same algorithm to the code actually entered.

**QUESTION: 94**

Which of the following computerized control procedures would be most effective in ensuring that data uploaded from desktop computers to a server are complete and that no additional data are added?

- A. Self-checking digits to ensure that only authorized part numbers are added to the database.
- B. Batch control totals, including control totals and hash totals.
- C. Passwords that effectively limit access to only those authorized to upload the data to the mainframe computer.
- D. Field-level edit controls that test each field for alphanumeric integrity.

**Answer: B**

Batch control totals for the data transferred can be reconciled with the batch control totals in the existing file. This comparison provides information on the completion of the data transfer. Batch totals may include record counts, totals of certain critical amounts, or hash totals. A hash total is a control total without a defined meaning, such as the total of employee numbers or invoice numbers, that is used to verify the completeness of data. Thus, the hash total for the employee listing by the personnel department could be compared with the total generated during the payroll run.

**QUESTION: 95**

When assessing application controls, which one of the following input controls or edit checks is most likely to be used to detect a data input error in the customer account number field?

- A. Limit check.
- B. Validity check.
- C. Control total.
- D. Hash total.

**Answer: B**

Validity checks are tests of identification numbers or transaction codes for validity by comparison with items already known to be correct or authorized. For example, Social Security numbers on payroll input records can be compared with Social Security numbers authorized by the personnel department.

**QUESTION: 96**

Omen Company is a manufacturer of men's shirts. It distributes weekly sales reports to each sales manager. The quantity 2R5 appeared in the quantity sold column for one of the items on the weekly sales report for one of the sales managers. The most likely explanation for what has occurred is that the

- A. Output quantity has been stated in hexadecimal numbers.
- B. Computer has malfunctioned during execution.
- C. Printer has malfunctioned and the "R" should have been a decimal point.

D. Program did not contain a data checking routine for input data.

**Answer: D**

The probable explanation for reporting a quantity using a character other than a digit is that the data were incorrectly encoded and the computer program did not perform a field check, which would have detected the error. A field check tests whether a field consists of the proper characters, whether alphanumeric, numeric, special, or combinations thereof.

**QUESTION: 97**

The online data entry control called preformatting is

- A. A program initiated prior to regular input to discover errors in data before entry so that the errors can be corrected.
- B. A check to determine if all data items for a transaction have been entered by the person entering the data.
- C. A series of requests for required input data that requires an acceptable response to each request before a subsequent request is made.
- D. The display of a document with blanks for data items to be entered by the person entering the data.

**Answer: D**

To avoid data entry errors in online systems, a preformatted screen approach may be used. It is a screen prompting approach that involves the display on a monitor of a set of boxes for entry of specified data items. The format may even be in the form of a copy of a transaction document. This technique is best suited to conversion of data from a source document.

**QUESTION: 98**

A catalog company has been experiencing an increasing incidence of problems in which the wrong products have been shipped to the customer. Most of the customer orders come in over the telephone, and an operator enters the data into the order system immediately. Which of the following control procedures, if properly implemented, would address the problem?

- I. Have the computer automatically assign a sequential order number to each customer order.
- II. Implement a self-checking digit algorithm for each product number and request entries by product number.
- III. Request entries by product number, have the computer program identify the product and price, and require the operator to orally verify the product description with the customer.

- A. II only.
- B. I, II, and III.
- C. II and III only.
- D. I and II only.

**Answer: C**

A self-checking digit detects incorrect codes. The digit is generated by applying an algorithm to the code. During input, the digit is recomputed by applying the algorithm to the code actually entered. Oral verification also addresses the problem of incorrectly identifying the product number. Assigning a sequential number to the customer's order helps build an audit trail but does not address the product identification issue.



**QUESTION: 99**

Which one of the following input controls or edit checks would catch certain types of errors within the payment amount field of a transaction?

- A. Record count.
- B. Echo check.
- C. Check digit.
- D. Limit check.

**Answer: D**

A limit, reasonableness, or range test determines whether an amount is within a predetermined limit for given information. It can only detect certain errors i.e., those that exceed the acceptable limit).

**QUESTION: 100**

Which of the following should the auditor recommend as the most economical point at which to correct input errors in an online system?

- A Input data are balanced with computer-produced control totals.
- B Entry of data into each field of a record is completed.
- C Output data are balanced with computer-produced control totals and delivered to the user.
- D Entry of data into each record is completed.

**Answer: B**

The most economical point at which to correct input errors is at the earliest time after the data has been entered into the system. The earliest point is the entry of data into each field of a record. Errors can easily be rectified because the proper information is already available.

**QUESTION: 101**

The most common computer-related problem confronting organizations is

- A. Hardware malfunction.
- B. Input errors and omissions.
- C. Disruption to computer processing caused by natural disasters.
- D. Fraud.

**Answer: B**

The most common problem confronting an organization in its use of computers is erroneous or incomplete input. Input is especially susceptible to errors and omissions because of the substantial human intervention required. Comprehensive and effective input controls are necessary ensure that data stored in files or used in processing are not contaminated.

**QUESTION: 102**

If a control total were to be computed on each of the following data items, which would best be identified as a hash total for a payroll computer application?

- A  
Hours worked.
- B. Total debits and total credits.
- C            Net pay
- D            Department numbers.

Answer: D

The three types of control totals are record counts, financial totals, and hash totals Record counts establish the number of source documents and reconcile it to the number of output records. Financial totals compute dollar totals from source documents e.g.. the total dollar amount of invoices processes) and reconcile them with the output records. Hash totals add numbers on input documents that are not normally added e.g., department numbers), resulting in a total that is "meaningless" for any purpose other than this control. Batchelder Company has the following invoices in a batch:

<u>Invoice Number</u>	<u>Product</u>	<u>Quantity</u>	<u>Unit Price</u>
201	F10	150	\$ 5.00
202	G15	200	10.00
203	H20	250	25.00
204	K35	300	30.00

QUESTION: 103

Which of the following would Batchelder most likely use as a hash total?

- A. FG HK80
- B            4
- C. 204
- D. 810

Answer: D

Input controls in batch computer systems are used to determine that no data are lost or added to the batch. Depending on the sophistication of a particular system. control may be accomplished by using record counts, batch totals, or hash totals. The hash total is a control total without a defined meaning, such as the total of employee numbers or invoice numbers, that is used to verify the completeness of data. The hash total of the invoice numbers is 810. Batchelder Company has the following invoices in a batch:

<u>Invoice Number</u>	<u>Product</u>	<u>Quantity</u>	<u>Unit Price</u>
201	F10	150	\$ 5.00
202	G15	200	10.00
203	H20	250	25.00
204	K35	300	30.00

QUESTION: 104

Which of the following would Batchelder most likely use as a record count?

- A. 1
- B. 4
- C. 810
- D. 900

Answer: B

Input controls in batch computer systems are used to determine that no data are lost or

added to the batch. Depending on the sophistication of a particular system, control may be accomplished by using record counts, batch totals, or hash totals. A record count establishes the number of source documents and reconciles it to the number of output records. The total number of invoices processed is an example of a record count. In this case, the record count is 4.

**QUESTION: 105**

In an order-entry system in which manually-prepared source documents are entered online for immediate processing, which of the following is an example of an appropriate input-output control?

- A. Password authorization procedure
- B. Check-digit validation procedure.
- C. Hash total verification.
- D. Backup and recovery procedures.

**Answer: B**

Self-checking digits may be used to detect incorrect identification numbers. The digit is generated by applying an algorithm to the ID number. During the input process, the check digit is recomputed by applying the same algorithm to the code actually entered.

**QUESTION: 106**

A customer intended to order 100 units of product 296014, but incorrectly ordered nonexistent product 296015. Which of the following controls most likely would detect this error?

- A. Check digit verification.
- B. Record count.
- C. Hash total.
- D. Redundant data check.

**Answer: A**

Check digit verification is used to identify incorrect identification numbers. The digit is generated by applying an algorithm to the ID number. During input, the check digit is recomputed by applying the same algorithm to the entered ID number.

**QUESTION: 107**

A validation check used to determine if a quantity ordered field contains only numbers is an example of a(n)

- A. Input control.
- B. Audit trail control.
- C. Processing control.
- D. Data security control.

**Answer: A**

A validation check at data entry verifying that a quantity field contains only numbers is an example of a programmatic means of ensuring the accuracy of an input value. Thus, it is an input control.

**QUESTION: 108**

An accounts payable program posted a payable to a vendor not included in the online vendor master file. A control that would prevent this error is a

- A. Validity check.
- B. Range check.
- C. Reasonableness test.
- D. Parity check.

**Answer: A**

Validity checks are tests of identification numbers or transaction codes for validity by comparison with items already known to be correct or authorized. For example, social security numbers on payroll input records can be compared with Social Security numbers authorized by the personnel department.

**QUESTION: 109**

Which one of the following input validation routines is not likely to be appropriate in a real-time operation?

- A. Sign check
- B. Reasonableness check.
- C. Sequence check
- D. Redundant data check.

**Answer: C**

the program controls listed prescreen or edit data prior to processing, but the sequence check is most likely to be used only in batch processing. A sequence check lets to determine that records are in proper order. For example, a payroll input file can be sorted into Social Security number order. A sequence check can then be performed to verify record order. This control would not apply in a real-time operation because records are not processed sequentially.

**QUESTION: 110**

An employee in the receiving department keyed in a shipment to the accounts payable system and inadvertently omitted the purchase order number. The best systems control to detect this error is

- A. Completeness test.
- B. Sequence check.
- C. Reasonableness test.
- D. Compatibility test.

**Answer: A**

A completeness test checks that all data elements are entered before processing. An interactive system can be programmed to notify the user to enter the number before accepting the receiving report.

**QUESTION: 111**

A manufacturer is considering using bar code identification for recording information on parts used by the manufacturer. A reason to use bar codes rather than other means of

identification is to ensure that

- A. The movement of all parts is recorded.
- B. The movement of parts is easily and quickly recorded.
- C. Vendors use the same part numbers.
- D. Vendors use the same identification methods.

**Answer:** B

Bar code scanning is a form of optical character recognition. Bar codes are a series of bars of different widths that represent critical information about the item. They can be read and the information can be instantly recorded using a scanner. Thus, bar coding records the movement of parts with minimal labor costs.

**QUESTION:** 112

To avoid invalid data input, a bank added an extra number at the end of each account number and subjected the new number to an algorithm. This technique is known as

- A. Sequence check.
- B. A check digit.
- C. Cross-footing.
- D. Field check.

**Answer:** B

Self-checking digits may be used to detect incorrect identification numbers. A check digit is an extra reference number that follows an identification code and bears a mathematical relationship to the other digits. The extra digit is input with the data. The identification code can be subjected to an algorithm and compared to the check digit.

**QUESTION:** 113

What technique could be used to prevent the input of alphabetic characters into an all-numeric identification number?

- A. A sequence check.
- B. A check digit.
- C. A record count
- D. A format check.

**Answer:** D

With a format check, the computer checks the characteristics of the character content length, or sign of the individual data fields. Field checks, sign checks, and range checks are examples of format checks.

**QUESTION:** 114

Which of the following actions would best address a concern that data uploaded from a desktop computer may be erroneous?

- A. The mainframe computer should be backed up on a regular basis.
- B. Two persons should be present at the desktop computer when it is uploading data.
- C. The mainframe computer should subject the data to the same edits and validation routines that online data entry would require.

D. Users should be required to review a random sample of processed data.

**Answer: C**

The same edits and validation routines used for online data entry should be applied to data uploaded from a desktop computer. This could help prevent data errors.

**QUESTION: 115**

Unauthorized alteration of online records can be prevented by employing

- A. Key verification.
- B. Computer sequence checks.
- C. Computer matching.
- D. Database access controls.

**Answer: D**

Users can gain access to databases from terminals only through established recognition and authorization procedures: thus, unauthorized access is prevented.

**QUESTION: 116**

When two devices in a data communications system are communicating, there must be agreement as to how both data and control information are to be packaged and interpreted. Which of the following terms is commonly used to describe this type of agreement?

- A. Asynchronous communication.
- B. Synchronous communication.
- C. Communication channel.
- D. Communication protocol.

**Answer: D**

A protocol is a set of formal rules or conventions governing communication between a sending and a receiving device. It prescribes the manner by which data are transmitted between these communications devices. In essence, a protocol is the envelope within which each message is transmitted throughout a data communications network.

**QUESTION: 117**

A real estate brokerage firm is moving into a building that is already equipped with extensive telephone wiring. The firm is considering the installation of a digital private branch exchange (PBX) to connect computers and other office devices, such as copying machines, printers, and fax machines. A limitation of using a PBX-based system for this network is that

- A. The firm would be dependent on others for system maintenance.
- B. The system cannot easily handle large volumes of data.
- C. Coaxial cabling would have to be installed throughout the building.
- D. Relocating devices in the office would be difficult and expensive.

**Answer: B**

A PBX has the advantage of using existing telephone lines and therefore not needing

special wiring. Moreover, equipment can be moved without necessitating rewiring. However, because PBX-based systems use telephone wiring (most often copper wire), they cannot easily handle large volumes of data.

**QUESTION: 118**

Large organizations often have their own telecommunications networks for transmitting and receiving voice, data, and images. Very small organizations, however, are unlikely to be able to make the investment required for their own networks and are more likely to use

- A. Public switched lines.
- B. Fast-packet switches.
- C. Standard electronic mail systems.
- D. A WAN.

**Answer: A**

Companies can use public switched lines (phone lines) on a per-transmission basis. This option is the most cost-effective way for low-volume users to conduct telecommunications.

**QUESTION: 119**

A local area network (LAN) is best described as a(n)

- A. Computer system that connects computers of all sizes, workstations, terminals, and other devices within a limited proximity.
- B. System to allow computer users to meet and share ideas and information.
- C. Electronic library containing millions of items of data that can be reviewed, retrieved, and analyzed.
- D. Method to offer specialized software, hardware, and data-handling techniques that improve effectiveness and reduce costs.

**Answer: A**

A LAN is a local distributed computer system, often housed within a single building. Computers, communication devices, and other equipment are linked by cable. Special software facilitates efficient data communication among the hardware devices.

**QUESTION: 120**

Using a telecommunications provider affects in-house networks. To prepare for changes resulting from enhanced external network services, management should

- A. Optimize in-house networks to avoid bottlenecks that would limit the benefits offered by the telecommunications provider.
- B. Plan for rapid implementation of new capabilities in anticipation of ready acceptance of the new technology.
- C. Downsize the company's disaster recovery plan to recognize the increasing role of the telecommunications provider.
- D. Enhance the in-house network management to minimize dependence on the telecommunications provider for network management.

**Answer: A**

To prepare the company for changes resulting from the enhanced external network services, management should take appropriate action. A number of bottlenecks may limit

the benefits that can be derived from the external network. For example, conversion from analog to digital technology is necessary to achieve rapid improvements in bandwidth and speed and to improve access to telecommunications services. Furthermore, applications, systems software, and communications protocols must be able to process information in a format and in a manner acceptable to end users. Communications security also has heightened importance as greater amounts of data are transmitted from remote sites.

**QUESTION: 121**

Which of the following represents the greatest exposure to the integrity of electronic funds transfer data transmitted from a remote terminal?

- A. Poor physical access controls over the data center.
- B. Network viruses\_
- C. Poor system documentation.
- D. Leased telephone circuits.

**Answer: D**

Leased telephone circuits represent a direct exposure to the risk of breached data integrity. They use public lines that can be easily identified and tapped.

**QUESTION: 122**

Which of the following is false with respect to client-server networks?

- A. A client-server network divides processing of an application between a client machine on a network and a server.
- B. In a client-server network, many applications reside on the client computer.
- C. The server customarily manages peripheral hardware and control; a,::,,-. .;hared databases.
- D. A client-server network can cope with only 12 or fewer clients at a time.

**Answer: D**

A client-server network can cope with thousands of clients at a time. They can access the server over the Internet from any where at any time with no time-related charges.

**QUESTION: 123**

Which of the following networks provides the least secure means of data transmission?

- A. Value-added.
- B. Public-switched.
- C. Local area.
- D. Private.

**Answer: B**

Public-switched networks are wide area networks that use public telephone lines. This arrangement may be the most economical, but data transmission may be of lower quality, no connection may be available, and security measures may be ineffective.

**QUESTION: 124**

A local area network (LAN) is best described as a(n)



- A. Computer system that connects computers of all sizes, workstations, terminals, and other devices within a limited proximity.
- B. System to allow computer users to meet and share ideas and information.
- C. Electronic library containing millions of items of data that can be reviewed, retrieved, and analyzed.
- D. Method to offer specialized software, hardware, and data handling techniques that improve effectiveness and reduce costs.

**Answer:** A

A LAN is a local distributed computer system, often housed within a single building. Computers, communication devices, and other equipment are linked by dedicated channels. Special software facilitates efficient data communication among the hardware devices.

**QUESTION:** 125

If a system does not have a mainframe computer or a file server but does processing within a series of personal computers, the network is a(n)

- A. Offline processing system.
- B. Expert system.
- C. Direct access system.
- D. Peer-to-peer system.

**Answer:** D

A local area network is a user-controlled network that operates without the assistance of a common carrier. It can have several personal computers attached to a host computer, can be linked as part of several LANs that may or may not communicate with a host computer, or can be connected together but not connected to a host computer stand alone). A peer-to-peer network operates without a mainframe or file server.

**QUESTION:** 126

Which of the following is considered to be a server in a local area network LAN)?

- A. The cabling that physically interconnects the nodes of the LAN.
- B. A device that stores program and data files for users of the LAN.
- C. A device that connects the LAN to other networks.
- D. A workstation that is dedicated to a single user on the LAN.

**Answer:** B

A file server is a computer in a network that operates as a librarian. It stores programs and data files for users of the LAN and manages access to them.

**QUESTION:** 127

A type of network that is used to support interconnections within a building is known as a

- A. Local area network.
- B. Wide area network.
- C. Metropolitan area network.
- D. Value-added network.

**Answer: A**

A communications network consists of one or more computers and their peripheral equipment linked together. Local-area networks (LANs) link together hardware and other equipment within a limited area, such as a building, so that users can share data and hardware devices.

**QUESTION: 128**

An electronic meeting conducted between several parties at remote sites is referred to as

- A. Teleprocessing.
- B. Interactive processing.
- C. Telecommuting.
- D. Teleconferencing.

**Answer: D**

Conducting an electronic meeting among several parties at remote sites is teleconferencing. It can be accomplished by telephone or electronic mail group communication software. Videoconferencing permits the conferees to see each other on video screens. The practice has grown in recent years as companies have attempted to cut their travel costs.

**QUESTION: 129**

Which of the following statements about voice communications is true?

- A. Modern voice recognition input devices have large vocabularies and short training periods.
- B. A voice output device converts speech into digital data.
- C. Cell phones and PCS services use the same frequency radio waves.
- D. Pagers can alert users to the receipt of messages but cannot transmit text.

**Answer: A**

Voice recognition input devices provide an alternative to keyboard input. These systems compare the speaker's voice patterns with prerecorded patterns. Advanced systems now have large vocabularies and shorter training periods. They allow for dictation and are not limited to simple commands.

**QUESTION: 130**

Response time on a local area network (LAN) was so slow that programmers working on applications kept their code on their own workstations rather than on the server. As a result, daily backups of the server did not contain the current source code. The best approach to detect deteriorating response time is

- A. Parallel testing.
- B. Integrated test facility.
- C. Performance monitoring.
- D. Program code comparison software.

**Answer: C**

Performance monitoring is the systematic measurement and evaluation of operating results

such as transaction rates, response times, and incidence of error conditions. Performance monitoring will reveal trends in capacity usage so that capacity can be upgraded before response deteriorates to the point that users behave in unintended or undesirable ways.

**QUESTION:** 131

Which of the following computer hardware devices allows for an immediate update of merchandise inventory in a retail environment?

- A. Inventory control terminal.
- B. Monitor.
- C. Video display terminal.
- D. Point-of-sale terminal.

**Answer:** D

Point-of-sale terminals capture data by optical scanning or by keying. The data are then transmitted to a CPU. The system permits collection of sales data, updating and ordering of inventory, pricing at the point of sale, and checking of customer credit cards.

**QUESTION:** 132

A device used to connect dissimilar networks is a

- A. Gateway.
- B. Bridge.
- C. Router.
- D. Wiring concentrator.

**Answer:** A

A gateway, often implemented via software, translates between two or more different protocol families and makes connections between dissimilar networks possible.

**QUESTION:** 133

The most difficult aspect of using Internet resources is

- A. Making a physical connection.
- B. Locating the best information source.
- C. Obtaining the equipment required.
- D. Getting authorization for access.

**Answer:** B

The most difficult aspect of using Internet resources is locating the best information given the large number of information sources.

**QUESTION:** 134

Which of the following risks is not greater in an electronic funds transfer (EFT) environment than in a manual system using paper transactions?

- A. Unauthorized access and activity.
- B. Duplicate transaction processing.
- C. Higher cost per transaction.

D. Inadequate backup and recovery capabilities.

**Answer:** C

EFT is a service provided by financial institutions worldwide that is based on EDI technology. EFT transaction costs are lower than for manual systems because documents and human intervention are eliminated from the transactions process.

**QUESTION:** 135

Which of the following is usually a benefit of using electronic funds transfer (EFT) for international cash transactions?

- A. Improvement of the audit trail for cash receipts and disbursements.
- B. Creation of self-monitoring access controls.
- C. Reduction of the frequency of data entry errors.
- D. Off-site storage of source documents for cash transactions.

**Answer:** C

The processing and transmission of electronic transactions, such as EFTs, virtually eliminates human interaction. This process not only helps eliminate errors but also allows for the rapid detection and recovery from errors when they do occur.

**QUESTION:** 136

Which of the following is a risk that is higher when an electronic funds transfer (EFT) system is used?

- A. Improper change control procedures.
- B. Unauthorized access and activity.
- C. Insufficient online edit checks.
- D. Inadequate backup and disaster recovery procedures.

**Answer:** B

Unauthorized access to money transfer activities or data is an inherent and unique risk of EFT systems. An unauthorized person may attempt to read, alter, or delete information in data files or to enter unauthorized fund transfers. Hence, in the financial services industry, protection of confidential customer transactions is especially important. Moreover, unauthorized transfers subject a financial institution to a direct risk of serious loss.

**QUESTION:** 137

If electronic funds transfer (EFT) is used to pay vendor invoices, which of the following computer-assisted audit procedures would an auditor use to determine if any payments were made twice?

- I. Testing of EFT transactions for reasonableness.
- II. Identification of EFT transactions to the same vendor for the same dollar amount.
- III. Extraction of EFT transactions with unauthorized vendor codes.
- IV. Searching for EFT transactions with duplicate purchase order numbers.

- A. I and II only.
- B. I and IV only.
- C. II and III only.
- D. III and IV only.

**Answer:** B

EFT is a service provided by financial institutions worldwide that is based on EDI technology. EFT transaction costs are lower than for manual systems because documents and human intervention are eliminated from the transactions process. Inaccurate transaction processing (including duplication) is a risk specific to EFT. Thus, an auditor should 1) review transactions with the same vendor for the same amount and 2) search for transactions with duplicate purchase order numbers. However, selection of transactions with unauthorized vendor codes and testing of transactions for reasonableness do not identify duplicate payments.

**QUESTION: 138**

All of the following are potential security issues for e-commerce except

- A. Correct identification of transacting parties.
- B. Proliferation of computer viruses.
- C. Determining who may rightfully make transaction decisions.
- D. Verification of payment data.

**Answer: B**

E-commerce is the purchase and sale of goods and services by electronic means. E-commerce may occur via online transactions on public networks (electronic data interchange EDI), and email. E-commerce security issues include the correct identification of transacting parties (authentication), determining who may rightfully make decisions (authorization), and verification of payment data. While proliferation of computer viruses is a general security issue with regard to information systems, it is not a specific risk associated with e-commerce.

**QUESTION: 139**

ABC Company is a clothing retailer. Greg is an employee of ABC Company and has recently purchased a leather jacket from ABC Company's website. This activity is

- A. An e-commerce activity characterized as B2C
- B. An e-commerce activity characterized as B2E.
- C. An e-commerce activity characterized as B2B.
- D. Not an e-commerce activity because Greg is an employee of ABC Company.

**Answer: A**

Electronic commerce (e-commerce) is generally defined as "conducting commercial activities over the Internet. These commercial activities can be business-to-business (B2B), business-to-consumer (B2C), and business-to-employee (B2E). The activity that took place between Greg and ABC Company is best characterized as a business-to-consumer activity. The transaction was with an individual who was not performing an employee function.

**QUESTION: 140**

When performing an e-commerce engagement, the greatest two concerns about the internal audit activity are

- A. Independence and competency.
- B. Capacity and objectivity.
- C. Competency and objectivity.
- D. Capacity and competency.

**Answer: D**

The chief audit executive's (CAE's) concerns about performing an e-commerce engagement

are the competency and capacity of the internal audit activity. Among the possible factors that may limit the internal audit activity are the following:

- Does the internal audit activity have sufficient skills? If not, can the skills be acquired?
- Are training or other resources necessary?
- Is the staffing level sufficient for the near term and long term?
- Can the expected audit plan be delivered?

**QUESTION:** 141

Which of the following is not a major component of an audit of e-commerce activities?

- A. Make certain that goals and objectives can be achieved.
- B. Assess the internal control structure.
- C. Review the interface issues.
- D. Evaluate the business continuity and disaster recovery plans.

**Answer:** A

Auditing e-commerce activities should provide reasonable assurance - not ensure or make certain -that goals and objectives can be achieved. An auditor cannot be absolutely certain that goals and objectives will be achieved. The following are other major components of an audit of e-commerce activities:

- Assess the internal control structure, including the tone set by senior management, Determine whether the risks are acceptable.
- Understand the information flow.
- Review the interface issues such as hardware to hardware, software to software, and hardware to software), and
- Evaluate the business continuity and disaster recovery plans.

**QUESTION:** 142

Which of the following pieces of information is useful to an internal auditor who is conducting a risk assessment for an e-commerce project?

- I. The business plan for the e-commerce project
- II. The level of functionality required to meet the end user's needs as well as management's objectives.
- III. The results of a risk assessment performed to evaluate impact of internal and external forces RRR.

- A. I and II only\_
- B. I and III only.
- C. II and III only.
- D. I, II, and III.

**Answer:** D

The IIA's SAC publication can assist the internal auditor in audit planning and risk assessment. It includes a list of e-commerce areas that should be of interest to an internal auditor who is undertaking an engagement and assessing risks. The questions for the internal auditor to consider are listed in PA 2100-6, Control and Audit Implications of E-commerce Activities. All of the information given constitutes answers to some of the questions listed.

**QUESTION:** 143

Which type of risks assumed by management are often drivers of organizational activities?

- A Opportunity risks
- B. Inherent risks.
- C. General project management risks.
- D. Control risks.

**Answer:** A

Risk can be defined as the uncertainty of an event occurring that could have a negative impact on the achievement of objectives. Risk is inherent to every business or government entity. Opportunity risks assumed by management are often drivers of organizational activities. Beyond these opportunities may be threats and other dangers that are not clearly understood or fully evaluated and are too easily accepted as part of doing business\_

**QUESTION:** 144

What is the overall audit objective when auditing an e-commerce activity?

- A To ensure that all e-commerce processes have efficient internal controls.
- B To ensure that all e-commerce processes have effective internal controls.
- C To ensure that all e-commerce processes are adequate to fulfill their intended objectives.
- D To ensure that all e-commerce processes meet the functionality requirements of the end users.

**Answer:** B

According to PA 2100-6, when auditing e-commerce activities, the overall audit objective should be to ensure that all e-commerce processes have effective internal controls.

**QUESTION:** 145

Which of the following is not a condition that the internal auditor should be alert for when testing for fraud in an e-commerce audit?

- A. Denial of service attacks.
- B. Duplication of payments.
- C. Denial of orders placed or received.
- D. Exception reports and procedures.

**Answer:** A

According to the outline of a possible e-commerce audit protocol for key areas given in PA 2100-6, the internal auditor should be alert for the following conditions with respect to fraud:

- Unauthorized movement of money e.g., transfers to jurisdictions where the recovery of funds would be difficult).
- Duplication of payments.
- Denial of orders placed or received, goods received, or payments made.
- Exception reports and procedures and effectiveness of the follow-up.
- Digital signatures: Are they used for all transactions? Who authorizes them? Who has access to them?
- Protections against viruses and hacking activities history file, use of tools).
- Access rights: Are they reviewed regularly? Are they promptly revised when staff members are changed? History of interception of transactions by unauthorized persons.

**QUESTION:** 146

An internal auditor is evaluating project management reviews of individual initiatives and development projects and system development life cycle reviews. When performing this

service, the internal auditor is addressing which key e-commerce audit area?

- A. Corruption of data.
- B. E-commerce organization.
- C. Management issued.
- D. Business interruptions.

**Answer: C**

According to the outline of a possible e-commerce audit protocol for key areas given in PA 2100-6, the internal auditor should evaluate how well business units are managing the e-commerce when addressing the possible key audit area of management issues. The following is a list of some relevant topics that the internal auditor should review when doing their evaluation:

- Project management reviews of individual initiatives and development projects.
- System development life cycle reviews.
- Vendor selection, vendor capabilities, employee confidentiality, and bonding.
- Post-implementation economic reviews: Are anticipated benefits being achieved? What metrics are being used to measure success?
- Post-implementation process reviews: Are new processes in place and working effectively?

**QUESTION: 147**

Management has implemented such controls as firewalls, password management, independent reconciliation, and audit trails\_ These controls should be reviewed and evaluated by the internal auditor when doing testing for which key e-commerce audit area?

- A. Fraud.
- B. Corruption of data.
- C. Business interruptions.
- D. Authentication.

**Answer: D**

An outline of a possible e-commerce audit protocol for key areas is given in PA 2100-6. In the outline, authentication is given as a possible key audit area, and to test for authentication, the internal auditor should review the policies for authenticating transactions and evaluating controls. Tools that management should have in place include firewalls, password management, independent reconciliation, and audit trails.

**QUESTION: 148**

What risk element is management seeking to identify by asking the following question: What could happen that would adversely affect the organization's ability to achieve its objectives and execute its strategies?

- A. Single loss exposure value.
- B. Safeguards and controls
- C. Threat events.
- D. Frequency.

**Answer: C**

PA 2100-6 poses seven key questions that can identify organizational risk and target potential ways to control or mitigate the exposures. Each question is associated with a risk element. The threat events element is associated with the given question\_



**QUESTION: 149**

The e-commerce project that an auditor is most likely to assess as having the lowest risk is one that

- A. Has a business plan that covers the integration of the planning, design, and implementation of the e-commerce system with the strategies of the organization.
- B. Considers governmental and regulatory requirements, and other external factors in its risk assessment.
- C. Calls for using outside vendors to provide hosting services.
- D. Addresses the security of the software and the accuracy of transaction processing.

**Answer: A**

The following are a few issues that an internal auditor should consider when undertaking an e-commerce engagement and assessing risks:

- Is there a business plan for the e-commerce project or program?
- Does the plan cover the integration of the planning, design, and implementation of the e-commerce system with the strategies of the organization?
- Have governmental and regulatory requirements been analyzed and considered?
- How secure is the hardware and software, and will they prevent or detect unauthorized access, inappropriate use, and other harmful effects and losses?
- Will transaction processing be current, accurate, complete, and indisputable? . Does the risk assessment include internal and external forces?
- If outside vendors are used, has a "going concern" evaluation been conducted by a trusted third party who is qualified to certify the vendor?
- If vendors provide hosting services, do they have a tested business contingency plan? Have they provided a recent SAS-70 report? Also, have privacy issues been resolved?

Based on how well the e-commerce project addresses these questions, the project likely to receive the lowest risk assessment is one that has a business plan that covers the integration of the planning, design, and implementation of the e-commerce system with the strategies of the organization.

**QUESTION: 150**

Electronic commerce (e-commerce) is generally defined as "conducting commercial activities over the Internet." These commercial activities can be all but which of the following?

- A. Business-to-business
- B. Business-to-consumer
- C. Business-to-employee
- D. Consumer-to-business.

**Answer: D**

These commercial activities can be business-to-business (B2B), business-to-consumer (B2C), and business-to-employee (B2E). Consumer-to-business is not a commercial activity because it does not originate from a business, therefore, it is not considered part of e-commerce.

**QUESTION: 151**

With regard to e-commerce, risk is best defined as the uncertainty of an event that could

- A. Have a negative impact on the achievement of objectives.

- B. Positively impact management's ability to safeguard organizational assets.
- C. Have a positive impact on the achievement of objectives\_
- D. Have an impact on the effective and efficient use of an organization's resources.

**Answer:** A

The e-commerce risk and control environment is complex and evolving. Risk can be defined as the uncertainty of an event occurring that could have a negative impact on the achievement of objectives.

**QUESTION:** 152

Which of the following is not one of the seven elements of risk?

- A. Frequency
- B. Timing.
- C. ROI analysis.
- D. Uncertainty.

**Answer:** B

The seven elements of risk are threat events, single loss exposure value, frequency, uncertainty, safeguards and controls, safeguard and control costs, and cost/benefit or ROI analysis. Timing, which is not a risk element, is when a risk may occur\_ It is different from frequency, which is how often an uncertain event might occur.

**QUESTION:** 153

Which of the following are elements of risk management and mitigation?

- I. Threat events and cost/benefit analysis
  - II. Safeguards, controls, and POI analysis
  - III. Frequency and uncertainty
  - IV. Safeguard and control costs
- A. I only
  - B. II only.
  - C. I and III only.
  - D. II and IV only.

**Answer:** D

The elements relating to risk management and mitigation include safeguards and controls, safeguard and control costs, and cost/benefit or POI analysis. The other elements of risk - threat events, single loss exposure value, frequency, and uncertainty- comprise risk identification and quantification.

**QUESTION:** 154

A decision not to participate in e-commerce should be carefully analyzed, documented, and approved by whom?

- A. The chief audit executive.
- B. The chief executive officer
- C. The governing board
- D. The audit committee.

**Answer: C**

The overall audit objective should be to ensure that all e-commerce processes have effective internal controls. Management of commerce initiatives should be documented in a strategic plan that is well developed and approved. If there is a decision not to participate in e-commerce, that decision should be carefully analyzed, documented, and approved by the governing board.

**QUESTION: 155**

Tools that should be in place to ensure data integrity include III

- I. Monitoring software
- II. Change controls
- III. Trend analysis
- IV. IV Automatic timeout

- A. I and III only.
- B. II, III, and IV only.
- C. I, III, and IV only.
- D. I, II, III, and IV.

**Answer: D**

The internal auditor should evaluate controls over data integrity. Tools that should be in place in order to ensure data integrity include intrusion management monitoring software, automatic timeout, and trend analysis), physical security for e-commerce servers, change controls, and reconciliation.

**QUESTION: 156**

Which of the following questions is best associated with the safeguards and controls risk element?

- A. What could happen that would adversely affect the organization's ability to achieve its objectives and execute its strategies?
- B. What can be done to prevent and avoid, mitigate, and detect risks and provide notification?
- C. What is the potential financial impact of the occurrence of an uncertain event?
- D. How often might an uncertain event occur?

**Answer: B**

For the purposes of management, there are seven key questions that can serve to identify organizational risk and target potential ways to control or mitigate the exposures. These questions, along with the risk elements associated with them in brackets), include the following:

- What could happen that would adversely affect the organization's ability to achieve its objectives and execute its strategies? [Threat Events]
- If it happens, what is the potential financial impact? [Single Loss Exposure Value]
- How often might it happen? [Frequency]
- How probable are the answers to the first three questions? [Uncertainty]
- What can be done to prevent and avoid, mitigate, and detect risks and provide notification? [Safeguards and Controls]
- How much will it cost? [Safeguards and Control Costs]
- How efficient would that be? [Cost/Benefit or ROI Analysis]

**QUESTION: 157**

Which of the following are critical risk and control issues that an internal auditor must address?

- I Rapid technology changes
- II Maintenance of transaction integrity
- III. Website content review and approval
- IV. Changes to organizational structures

- A. I and II only.
- B. I and III only.
- C. II and III only
- D. I, II, III, and IV.

**Answer:** D

Some of the more critical risk and control issues to be addressed by the internal auditor are

- General project management risks
- Specific security threats, such as denial of service, physical attacks, viruses, identity theft, and unauthorized access or disclosure of data
- Maintenance of transaction integrity under a complex network of links to legacy systems and data warehouses
- Website content review and approval when there are frequent changes and sophisticated customer features and capabilities that offer around-the-clock service
- Rapid technology changes
- Legal issues, such as increasing regulations throughout the world to protect individual privacy, enforceability of contracts outside of the organization's country, and tax and accounting issues
- Changes to surrounding business processes and organizational structures

**QUESTION:** 158

The details of the audit program used to audit e-commerce activities in specific organizations will vary depending on all but which of the following factors?

- A. Industry.
- B. Organizational culture
- C. Country.
- D. Legal and business models.

**Answer:** B

The details of the audit program used to audit e-commerce activities in specific organizations will vary depending on industry, country, and legal and business models.

**QUESTION:** 159

Security of monetary transactions is one example of an audit objective for an e-commerce engagement. Which of the following is not an audit objective for an e-commerce engagement?

- A. Effective use and control of digital signatures.
- B. Adequacy and timeliness of operating data and information.
- C. Effectiveness of customer authentication process.
- D. Appropriateness of reporting lines.

**Answer:** D

Audit objectives for an e-commerce engagement may include:

- Evidence of e-commerce transactions
- Availability and reliability of security system

Effective interface between e-commerce and financial systems

Security of monetary transactions

Effectiveness of customer authentication process

- Adequacy of business continuity processes, including the resumption of operations
- Compliance with common security standards

Effective use and control of digital signatures

Adequacy of systems, policies, and procedures to control Public Key Certificates using public key Documented evidence e if an effective system of internal control cryptographic techniques)

**QUESTION: 160**

Which of the following e-commerce audit protocol items relates to the area of fraud?

- A. Segregation of duties.
- B. Inadequacies in interfacing between e-commerce and financial management systems.
- C. Examination of service level agreements between buyer, supplier, and certification authority.
- D. Denial of orders placed or received, goods received, or payments made.

**Answer: D**

With regard to the e-commerce audit protocol in the area of fraud, the internal auditor should be alert for the following conditions:

- Unauthorized movement of money e.g., transfers to jurisdictions where the recovery of funds would be difficult).
- Duplication of payments.
- Denial of orders placed or received, goods received, or payments made.
- Exception reports and procedures, and effectiveness of the follow up.
- Digital signatures: Are they used for all transactions Who authorizes them Who has access to them Protections against viruses and hacking activities history file. use of tools).
- Access rights Are they reviewed regularly Are they promptly revised when staff members are changed?
- History of interception of transactions by unauthorized persons.

**QUESTION: 161**

Companies now can use electronic transfers to conduct regular business transactions. Which of the following terms best describes a system in which an agreement is made between two or more parties to electronically transfer purchase orders, sales orders, invoices, and/or other financial documents?

- A. Electronic mail email).
- B. Electronic funds transfer EFT).
- C. Electronic data interchange EDI).
- D. Electronic data processing EDP).

**Answer: C**

Electronic data interchange is the electronic transfer of documents between businesses. EDI was developed to enhance just-in-time JIT) inventory management. Advantages include speed, reduction of clerical errors, and elimination of repetitive clerical tasks and their costs. A multinational company has an agreement with a value-added network VAN) that provides the encoding and communications transfer for the company's electronic data interchange EDI) and electronic funds transfer EFT) transactions. Before transfer of data to the VAN, the company performs online preprocessing of the transactions. The internal auditor is responsible for assessing preprocessing controls. In addition, the agreement between the company and the VAN states that the internal auditor

is allowed to examine and report on the controls in place at the VAN on an annual basis. The contract specifies that access to the VAN can occur on a surprise basis during the second or third quarter of the company's fiscal year. This period was chosen so it would not interfere with processing during the VAN's peak transaction periods. This provision was not reviewed with internal auditing. The annual audit plan approved by the board of directors specifies that a full audit would be done during the current year.

**QUESTION: 162**

Which one of the following would not be included as a reason for the company to use EFT with the EDI system?

- A. To take advantage of the time lag associated with negotiable instruments.
- B. To allow the company to negotiate discounts with EDI vendors based upon prompt payment.
- C. To improve its cash management program.
- D. To reduce input time and input errors.

**Answer: A**

The float period is the time lag between transmittal of a regular check (a negotiable instrument) and its clearance through regular banking channels. Float is eliminated by EFT.

A multinational company has an agreement with a value-added network (VAN) that provides the encoding and communications transfer for the company's electronic data interchange (EDI) and electronic funds transfer (EFT) transactions. Before transfer of data to the VAN, the company performs online preprocessing of the transactions. The internal auditor is responsible for assessing preprocessing controls. In addition, the agreement between the company and the VAN states that the internal auditor is allowed to examine and report on the controls in place at the VAN on an annual basis. The contract specifies that access to the VAN can occur on a surprise basis during the second or third quarter of the company's fiscal year. This period was chosen so it would not interfere with processing during the VAN's peak transaction periods. This provision was not reviewed with internal auditing. The annual audit plan approved by the board of directors specifies that a full audit would be done during the current year.

**QUESTION: 163**

Which one of the following is least likely to be recommended by the auditor when an EDI-EFT system is being designed?

- A. The identity of the individual approving an electronic document should be stored as a data field.
- B. Disaster recovery plans should be established.
- C. Data security procedures should be written to prevent changes to data by unauthorized individuals.
- D. Remote access to electronic data should be denied.

**Answer: D**

One of the benefits of an EDI-EFT system is that it can provide remote access at any time from any place if telecommunications links are available. However, appropriate controls should prevent unauthorized access. A multinational company has an agreement with a value-added network (VAN) that provides the encoding and communications transfer for the company's electronic data interchange (EDI) and electronic funds transfer (EFT) transactions. Before transfer of data to the VAN, the company performs online preprocessing of the transactions. The internal auditor is responsible for assessing preprocessing controls. In addition, the agreement between the company and the VAN

states that the internal auditor is allowed to examine and report on the controls in place at the VAN on an annual basis. The contract specifies that access to the VAN can occur on a surprise basis during the second or third quarter of the company's fiscal year. This provision was included so it would not interfere with processing during the VAN's peak transaction periods. This provision was not reviewed with internal auditing. The annual audit plan approved by the board of directors specifies that a full audit would be done during the current year.

**QUESTION:** 164

Because the VAN did not provide the internal auditor with access to its system, that portion of the engagement work program was not completed. Which one of the following should not be done by the internal auditor?

- A. Include the scope limitation in the final engagement communication.
- B. Rewrite the work program to eliminate the step
- C. Obtain the approval of the chief audit executive
- D. Document the VAN's actions in the working papers.

**Answer:** B

A scope limitation is a restriction placed upon the IAA that precludes it from accomplishing its objectives and plans. Among other things, a scope limitation may restrict the performance of necessary engagement procedures. A scope limitation and its potential effect should be communicated, preferably in writing, to the governing authority. A VAN is an alternative to direct EDI communications between transacting parties. Consequently, it is a vital component of internal control over these transactions, and the internal auditor's inability to obtain access constitutes a material limitation on the scope of the engagement to evaluate risk exposures and the adequacy and effectiveness of internal control. As a result, the original engagement program should be annotated but not rewritten.

**QUESTION:** 165

Which of the following is usually a benefit of transmitting transactions in an electronic data interchange (EDI) environment?

- A. A compressed business cycle with lower year-end receivables balances.
- B. A reduced need to test computer controls related to sales and collections transactions.
- C. An increased opportunity to apply statistical sampling techniques to account balances.
- D. No need to rely on third-party service providers to ensure security.

**Answer:** A

EDI transactions are typically transmitted and processed in real time. Thus, EDI compresses the business cycle by eliminating delays. The time required to receive and process an order, ship goods, and receive payment is greatly reduced compared with that of a typical manual system. Accordingly, more rapid receipt of payment minimizes receivables and improves cash flow.

**QUESTION:** 166

The emergence of electronic data interchange (EDI) as standard operating practice increases the risk of

- A. Unauthorized third-party access to systems
- B. Systematic programming errors.
- C. Inadequate knowledge bases.



D. Unsuccessful system use.

**Answer:** A

EDI is the communication of electronic documents directly from a computer in one entity to a computer in another entity. EDI for business documents between unrelated parties has the potential to increase the risk of unauthorized third-party access to systems because more outsiders will have access to internal systems.

**QUESTION:** 167

Which of the following are essential elements of the audit trail in an electronic data interchange (EDI) system?

- A. Network and sender/recipient acknowledgments.
- B. Message directories and header segments.
- C. Contingency and disaster recovery plans.
- D. Trading partner security and mailbox codes.

**Answer:** A

An audit trail allows for the tracing of a transaction from initiation to conclusion. Network and sender/recipient acknowledgments relate to the transaction flow and provide for the tracking of transactions.

**QUESTION:** 168

Which of the following statements is true concerning internal control in an electronic data interchange (EDI) system?

- A. Preventive controls generally are more important than detective controls in EDI systems.
- B. Control objectives for EDI systems generally are different from the objectives for other information systems.
- C. Internal controls in EDI systems rarely permit control risk to be assessed at below the maximum.
- D. Internal controls related to the segregation of duties generally are the most important controls in EDI systems.

**Answer:** A

In general, preventive controls are more important than detective controls because the benefits typically outweigh the costs. In electronic processing, once a transaction is accepted, there is often little opportunity to apply detective controls. Thus, it is important to prevent errors or frauds before they happen.

**QUESTION:** 169

A control that a company can use to detect forged EDI messages is to

- A. Acknowledge all messages initiated externally with confirming messages.
- B. Permit only authorized employees to have access to transmission facilities.
- C. Delay action on orders until a second order is received for the same goods.
- D. Write all incoming messages to a write-once/read-many device for archiving.

**Answer:** A



If the company acknowledges messages initiated externally, the alleged sender will have the opportunity to recognize that it had not sent the message and will then be able to notify the company of the potential forgery. Then corrective action can be taken by the company.

**QUESTION:** 170

Which of the following is likely to be a benefit of electronic data interchange (EDI)?

- A. Increased transmission speed of actual documents.
- B. Improved business relationships with trading partners.
- C. Decreased liability related to protection of proprietary business data.
- D. Decreased requirements for backup and contingency planning.

**Answer:** B

Electronic data interchange is the electronic transfer of documents between businesses. EDI was developed to enhance just-in-time (JIT) inventory management. Advantages include speed, reduction of clerical errors, and elimination of repetitive clerical tasks and their costs. Improved business relationships result because of the mutual benefits conferred by EDI. Accordingly, some organizations require EDI.

**QUESTION:** 171

Which of the following is an accepted example of electronic data interchange?

- A. Request for an airline reservation by a travel agent.
- B. Withdrawal of cash from an automated teller by a bank's customer.
- C. Transfer of summary data from a local area network to a centralized mainframe.
- D. Placement of order entry transactions from a customer to its supplier.

**Answer:** D

EDI is the communication of electronic documents directly from a computer in one entity to a computer in another entity. Placement of order entry transactions from a customer to its supplier is an accepted use of EDI between trading partners.

**QUESTION:** 172

An internal auditor was performing an operational audit of the purchasing and accounts payable system. The audit objective was to identify changes in processes that would improve efficiency and effectiveness. Which of the following statements support the auditor's recommendation that electronic data interchange (EDI) be implemented within a company?

- I. There is a small number of transactions.
- II. There is a time-sensitive just-in-time purchase environment.
- III. There is a large volume of custom purchases.
- IV. There are multiple transactions with the same vendor.

- A. I only.
- B. II and IV only.
- C. I and III.
- D. II, III, and IV.

**Answer:** B

EDI is advantageous in a JIT environment because it provides the capacity for instantaneous ordering. Moreover, a JIT environment already is characterized by the close

vendor-purchaser cooperation required by an EDI system. Another reason for implementing an EDI system is that the purchaser has a large volume of transactions with the same vendor(s). Otherwise, EDI may not be cost efficient.

**QUESTION:** 173

The auditor determined that the risks associated with the EDI purchases were less than the risks associated with the purchases made through the traditional system. Which one of the following factors best supports this prioritization of risks?

- A. There are three vendors connected through EDI.
- B. About half of the materials are purchased through EDI.
- C. The internal auditors were involved with systems development and testing of the EDI software.
- D. The external auditor did not examine EDI purchase controls during the annual financial audit.

**Answer:** C

Sound controls mitigate the risks associated with EDI. The question states that the internal auditing department's prior involvement consisted of assessing and testing the EDI system. This review found no significant problems. Accordingly, the risk of the EDI system is decreased.

**QUESTION:** 174

In a review of an EDI application using a third-party service provider, the auditor should

- I. Ensure encryption keys meet ISO standards
- II. Determine whether an independent review of the service provider's operation has been conducted.
- III. Verify that only public-switched data networks are used by the service provider
- IV. Verify that the service provider's contracts include necessary clauses, such as the right to audit

- A. I and II.
- B. I and IV.
- C. II and III.
- D. II and IV.

**Answer:** D

An auditor should review trading partner agreements and contracts with third-party service providers. These documents should contain necessary clauses and appropriately limit liabilities. Moreover, legal counsel should have reviewed the agreements or contracts. An auditor should also determine whether the third-party service provider's operations and controls have been independently reviewed e.g., by public accountants).

**QUESTION:** 175

Regardless of whether a company develops, buys, leases, or pays for the use of the software for EDI transmissions, internal audit should be responsible for evaluating whether the software

- A Was developed in a controlled environment.
- B Is backed up adequately to permit recovery.
- C. Was acquired with adequate review by legal counsel.
- D. Meets business objectives.

**Answer: D**

An EDI application should meet business objectives and satisfy user and control requirements. The internal auditors should consider the organization's important EDI applications because they represent significant risk exposures and control problems. This role is within the scope of work of the internal auditors, who are charged with examining and evaluating internal control and the quality of performance in carrying out assigned responsibilities.

**QUESTION: 176**

A company using EDI tracked the functional acknowledgments from trading partners and issue warning messages if acknowledgments did not occur within a reasonable length of time. What risk was the company attempting to address by this practice?

- A. Transactions that have not originated from a legitimate trading partner may be inserted into the EDI network.
- B. Transmission of EDI transactions to trading partners may sometimes fail.
- C. There may be disagreement between the parties as to whether the EDI transactions form a legal contract.
- D. EDI data may not be accurately and completely processed by the EDI software.

**Answer: B**

Tracking of customers' functional acknowledgments, when required, will help to ensure successful transmission of EDI transactions. Some possible controls include the provision of end-to-end acknowledgments, particularly when multiple, interconnected networks are involved, and maintenance of a tickler file of outstanding functional acknowledgments, with issuance of warnings for those that are overdue.

**QUESTION: 177**

An audit of the electronic data interchange (EDI) area of a banking group revealed the facts listed below. Which one indicates the need for improved internal control?

- A. Employees may only access the computer system via an ID and an encrypted password.
- B. The system employs message sequencing as a way to monitor data transmissions.
- C. Certain types of transactions may only be made at specific terminals.
- D. Branch office employees may access the mainframe with a single call via modem.

**Answer: D**

The system should employ automatic dial-back to prevent intrusion by unauthorized parties. This procedure accepts an incoming modem call, disconnects, and automatically dials back a prearranged number to establish a permanent connection for data transfer or inquiry.

**QUESTION: 178**

Before authorizing payment of an EDI invoice, the computer automatically compares the invoice with the purchase order and receiving report data. When the system was being developed, the auditor reviewed the payment authorization program and made recommendations. Which one of the following was most likely recommended by the auditor for the situation in which the quantity invoiced is greater than the quantity received?

- A. Prepare an exception report.
- B. Pay the amount billed and adjust the inventory for the difference.
- C. Return the invoice to the vendor.

D. Authorize payment of the full invoice, but maintain an open purchase order record for the missing goods.

**Answer:** A

An exception report (error listing) should be issued so that company personnel can investigate the discrepancy, determine its cause, and take appropriate corrective action.

**QUESTION:** 179

Consider the following computer applications.

(a) At a catalog sales firm, as phone orders are entered into their computer, both inventory and credit are immediately checked.

(b) A manufacturer's computer sends the coming week's production schedule and parts orders to a supplier's computer.

Which statement below is true for these applications?

A. Both applications are examples of electronic data interchange (EDI).

B. Both applications are examples of online real-time processing (OLRT).

C. The first application is an example of EDI and the second an example of OLRT.

D. The first application is an example of OLRT and the second an example of EDI.

**Answer:** D

The catalog sales firm is using an online processing system known as an online, real-time system (OLRT). OLRT systems handle transactions as they are entered, processing the input and providing output soon enough to affect a current decision making process, e.g., inventory and credit status of phone call orders. The sending of upcoming production schedules and parts orders by a manufacturer's computer to a supplier's computer is an example of electronic data interchange (EDI). EDI is the communication of electronic documents directly from one entity's computer to another's computer.

**QUESTION:** 180

If implementing EDI with suppliers permitted more frequent orders and more frequent communication about them, a company could be more effective by using EDI to

A. Reduce costs by reducing raw materials inventory.

B. Ensure that it always maintained a 25-day buffer stock.

C. Track materials through production to completed orders.

D. Schedule production to reduce the number of setups required.

**Answer:** A

A well-managed company seeks to minimize the sum of the costs of holding and ordering inventory. An EDI system reduces the costs of ordering, thereby permitting the company to order more frequently. More frequent ordering reduces inventory and the associated holding costs.

**QUESTION:** 181

Two major retail companies, both publicly traded and operating in the same geographic area, have recently merged. The companies are approximately the same size and have audit departments. Company A has little EDI experience. Company B has invested heavily in information technology and has EDI connections with its major vendors. Which of the following is the least important risk factor in considering the ability to integrate the two companies' computer systems?

- A. The number of programmers and systems analysts employed by each company.
- B. The extent of EDI connections with vendors.
- C. The compatibility of existing operating systems and database structures.
- D. The size of company databases and the number of database servers used.

**Answer:** A

The number of systems personnel employed may reflect differences in operating philosophy (outsourcing vs. in-house development of applications). However, the number of personnel in each company is a less serious concern than the compatibility of hardware and software.

**QUESTION:** 182

After implementing EDI with suppliers, a company discovered a dramatic increase in the prices it paid the single supplier of some special materials for its primary product line. After consulting with the supplier, the company determined that the supplier had assumed the risk of not having inventory and raised its prices accordingly since the company was the only buyer for the special materials. The best approach for managing inventory in this situation is for the company to

- A. Give the supplier more information about expected use of the materials.
- B. Demand that the supplier reduce the prices of the materials.
- C. Find another supplier to replace the one charging higher prices.
- D. Change its product line so the special materials are no longer needed.

**Answer:** A

If the company gives the supplier more information about use of the materials, the supplier may be able to plan its production more effectively. It could then reduce its inventory of the materials and its inventory costs, thus permitting it to charge a lower price.

**QUESTION:** 183

Electronic data interchange (EDI) offers significant benefits to organizations, but it is not without certain major obstacles. Successful EDI implementation begins with which of the following?

- A. Mapping the work processes and flows that support the organization's goals.
- B. Purchasing new hardware for the EDI system.
- C. Selecting reliable vendors for translation and communication software.
- D. Standardizing transaction formats and data.

**Answer:** A

Marked benefits arise when EDI is tied to strategic efforts that alter, not mirror, previous practices. Applying EDI to an inefficient process results in continuing to do things the wrong way, only faster. Hence, the initial phase of EDI implementation includes understanding the organization's mission and an analysis of its activities as part of an integrated solution to the organization's needs.

**QUESTION:** 184

The best approach for minimizing the likelihood of software incompatibilities leading to unintelligible messages is for a company and its customers to

- A. Acquire their software from the same software vendor.
- B. Agree to synchronize their updating of EDI-related software.
- C. Agree to use the same software in the same ways indefinitely.
- D. Each write their own version of the EDI-related software.

**Answer:** B

EDI entails the exchange of common business data converted into standard message formats. Thus, two crucial requirements are that the participants agree on transaction formats and that translation software be developed to convert messages into a form understandable by other companies. Thus, if one company changes its software, its trading partners must also do so.

**QUESTION:** 185

Before sending or receiving EDI messages, a company should

- A. Execute a trading partner agreement with each of its customers and suppliers.
- B. Reduce inventory levels in anticipation of receiving shipments.
- C. Demand that all its suppliers implement EDI capabilities.
- D. Evaluate the effectiveness of its use of EDI transmissions.

**Answer:** A

Before sending or receiving EDI messages, a company should execute a trading partner agreement with its customers and suppliers. All parties should understand their responsibilities, the messages each will initiate, how they will interpret messages, the means of authenticating and verifying the completeness and accuracy of messages, the moment when the contract between the parties is effective, the [required level of security, etc.

**Section 2:** Sec Two (186 to 268)

**Details:** Regulatory, Legal, and Economic issues

**QUESTION:** 186

The practice of maintaining a test program library separate from the production program library is an example of

- A. An organizational control.
- B. Physical security.
- C. An input control.
- D. A concurrency control.

**Answer:** A

This separation is an organizational control. Organizational controls concern the proper segregation of duties and responsibilities within the information systems department. Although proper segregation is desirable, functions that would be considered incompatible if performed by a single individual in a manual activity are often performed through the use of an information systems program or series of programs. Thus, compensating controls may be necessary, such as library controls, effective supervision, and rotation of personnel. Segregating test programs makes concealment of unauthorized changes in production programs more difficult

**QUESTION:** 187

An organization's computer help-desk function is usually a responsibility of the

- A. Applications development unit.
- B. Systems programming unit.
- C. Computer operations unit.
- D. User departments

**Answer: C**

Help desks are usually a responsibility of computer operations because of the operational nature of their functions. A help desk logs reported problems, resolves minor problems, and forwards more difficult problems to the appropriate information systems resources, such as a technical support unit or vendor assistance.

**QUESTION: 188**

Which of the following terms best describes the type of control practice evidenced by a segregation of duties between computer programmers and computer operators?

- A. Systems development control.
- B. Hardware control.
- C. Applications control.
- D. Organizational control.

**Answer: D**

Organizational control concerns the proper segregation of duties and responsibilities within the information systems function. For example, programmers should not have access to the equipment, and operators should not have programming ability. Although proper segregation is desirable, functions that would be considered incompatible if performed by a single individual in a manual activity are often performed through the use of an information systems program or series of programs. Therefore, compensating controls may be necessary, such as library controls and effective supervision.

**QUESTION: 189**

When a new application is being created for widespread use in a large organization, the principal liaison between the IT function and the rest of an organization is normally a(n)

- A. End user.
- B. Application programmer.
- C. Maintenance programmer.
- D. Systems analyst

**Answer: D**

Systems analysts are specifically qualified to analyze and design computer information systems. They survey the existing system, analyze the organization's information requirements, and design new systems to meet those needs. Systems analysts communicate with the entire organization and act as a liaison between the organization and the IT function.

**QUESTION: 190**

For control purposes, which of the following should be organizationally segregated from the computer operations function?

- A. Data conversion.



- B. Surveillance of screen display messages.
- C. Systems development.
- D. Minor maintenance according to a schedule.

**Answer: C**

Systems development is performed by systems analysts and application programmers.

**QUESTION: 191**

In the organization of the IT function, the most important separation of duties is

- A. Not allowing the data librarian to assist in data processing operations.
- B. Assuring that those responsible for programming the system do not have access to data processing operations.
- C. Having a separate information officer at the top level of the organization outside of the accounting function.
- D. Using different programming personnel to maintain utility} programs from those who maintain the application programs.

**Answer: B**

Separation of duties is a general control that is vital in a computerized environment. Some separation of duties common in non-computerized environments may not be feasible in a computer environment. However, certain tasks should not be combined. Systems analysts and programmers should be separate from computer operators. Both programmers and analysts may be able to modify programs, files, and controls and should therefore have no access to those programs nor to computer equipment. Operators should not be assigned programming duties or responsibility for systems design and should have no opportunity to make changes in programs and systems.

**QUESTION: 192**

Which of the following represents an internal control weakness in a computer-based system?

- A. Computer programmers write and revise programs designed by analysts.
- B. The end users are responsible for reconciling reports and other output
- C. The computer librarian maintains custody and record keeping for computer application programs.
- D. Computer operators have access to operator instructions and the authority to change programs.

**Answer: D**

Computer operators need access to operator instructions. Otherwise, they could not perform their duties. Operators, however, should not have the authority to change computer programs.

**QUESTION: 193**

The duties properly assigned to an information security officer could include all of the following except

- A. Developing an information security policy for the organization.
- B. Maintaining and updating the list of user passwords.
- C. Commenting on security controls in new applications.



D. Monitoring and investigating unsuccessful access attempts.

**Answer: B**

The information security officer should not know user passwords. They are normally stored on a computer in encrypted format, and users change them directly.

**QUESTION: 194**

In a large organization, the biggest risk in not having an adequately staffed information center help desk is

- A. Increased difficulty in performing application audits.
- B. Inadequate documentation for application systems.
- C. Increased likelihood of use of unauthorized program code.
- D. Persistent errors in user interaction with systems.

**Answer: D**

The biggest risk in not having an adequately staffed help desk is that users will unknowingly persist in making errors in their interaction with the information systems.

**QUESTION: 195**

A controller became aware that a competitor appeared to have access to the company's pricing information. The internal auditor determined that the leak of information was occurring during the electronic transmission of data from branch offices to the head office. Which of the following controls would be most effective in preventing the leak of information?

- A. Asynchronous transmission.
- B. Encryption.
- C. Use of fiber-optic transmission lines.
- D. Use of passwords.

**Answer: B**

Encryption software uses a fixed algorithm to manipulate plain text and an encryption key (a set of random data bits used as a starting point for application of the algorithm) to introduce variation. Although data may be accessed by tapping into the transmission line, the encryption key is necessary to understand the data being sent.

**QUESTION: 196**

The use of message encryption software

- A. Guarantees the secrecy of data.
- B. Requires manual distribution of keys.
- C. Increases system overhead.
- D. Reduces the need for periodic password changes.

**Answer: C**

Encryption software uses a fixed algorithm to manipulate plain text and an encryption key (a set of random data bits used as a starting point for application of the algorithm) to introduce variation. The machine instructions necessary to encrypt and decrypt data constitute system overhead. As a result, processing speed may be slowed.

**QUESTION:** 197

Which of the following is an encryption feature that can be used to authenticate the originator of a document and ensure that the message is intact and has not been tampered with?

- A. Heuristic terminal.
- B. Perimeter switch.
- C. Default settings\_
- D. Digital signatures\_

**Answer:** D

Businesses and others require that documents sent over the Internet be authentic. To authenticate a document, a company or other user may transmit a complete plaintext document along with an encrypted portion of the same document or another standard text that serves as a digital signature. If the plaintext document is tampered with, the two will not match.

**QUESTION:** 198

The encryption technique that requires two keys, a public key that is available to anyone for encrypting messages and a private key that is known only to the recipient for decrypting messages, is

- A. Rivest, Shamir, and Adelman RSA).
- B. Data encryption standard DES).
- C. Modulator-demodulator.
- D. A cypher lock.

**Answer:** A

RSA is an encryption standard licensed to hardware and software vendors. Public-key encryption requires management of fewer keys for a given client-server environment than does private-key encryption. However, compared with DES, RSA entails more complex computations and therefore has a higher processing overhead. RSA requires two keys: The public key for encrypting messages is widely known. but the private key for decrypting messages is kept secret by the recipient.

**QUESTION:** 199

A client communicates sensitive data across the Internet. Which of the following controls would be most effective to prevent the use of the information if it were intercepted by an unauthorized part}?

- A. A firewall\_
- B. An access log.
- C. Passwords.
- D. Encryption.

**Answer:** D

Encryption technology converts data into a code. Encoding data before transmission over communications lines makes it more difficult for someone with access to the transmission to understand or modify its contents.

**QUESTION: 200**

To ensure privacy in a public key encryption system, knowledge of which of the following keys would be required to decode the received message?

- I. Private
- II. Public

- A. I.
- B. II.
- C. Both I and II.
- D Neither I nor IL

**Answer: A**

In a public key system, the public key is used to encrypt the message prior to transmission, whereas the private key is needed to decrypt decode) the message.

**QUESTION: 201**

To reduce security exposure when transmitting proprietary data communication lines, a company should use

- A. Asynchronous modems.
- B. Authentication techniques
- C. Call-back. procedures.
- D. Cryptographic devices.

**Answer: D**

Encryption involves using a fixed algorithm to manipulate plaintext The information is sent in its manipulated form and the receiver translates the information back into plain text. Cryptographic devices protect data in transmission over communication lines.

**QUESTION: 202**

Which of the following is a computer program that appears to be legitimate but performs some illicit activity when it is run?

- A. Hoax virus.
- B. Web crawler.
- C. Trojan horse.
- D. Killer application.

**Answer: C**

A Trojan horse is a computer program that appears friendly, for example, a game, but that actually contains an application destructive to the computer system.

**QUESTION: 203**

The best preventive measure against a computer virus is to

- A. Compare software in use with authorized versions of the software.
- B. Execute virus exterminator programs periodically on the system.
- C. Allow only authorized software from known sources to be used on the system.
- D. Prepare and test a plan for recovering from the incidence of a virus.

**Answer: C**

Preventive controls are designed to prevent errors before they occur. Detective and corrective controls attempt to identify and correct errors. Preventive controls are usually more cost beneficial than detective or corrective controls. Allowing only authorized software from known sources to be used on the system is a preventive measure. The authorized software are from known sources is expected to be free of viruses.

**QUESTION: 204**

Which of the following is an indication that a computer virus is present?

- A. Frequent power surges that harm computer equipment.
- B. Unexplainable losses of or changes to data.
- C. Inadequate backup, recovery, and contingency plans.
- D. Numerous copyright violations due to unauthorized use of purchased software.

**Answer: B**

The effects of computer viruses range from harmless messages to complete destruction of all data within the system. A symptom of a virus would be the unexplained loss of or change to data.

**QUESTION: 205**

Managers at a consumer products company purchased personal computer software from only recognized vendors and prohibited employees from installing nonauthorized software on their personal computers. To minimize the likelihood of computer viruses infecting any of its systems, the company should also

- A. Restore infected systems with authorized versions.
- B. Recompile infected programs from source code backups.
- C. Institute program change control procedures.
- D. Test all new software on a stand-alone personal computer.

**Answer: D**

Software from recognized sources should be tested in quarantine for example, in a test development machine or a stand-alone personal computer) because even vendor-supplied software may be infected with viruses. The software should be run with a vaccine program and tested for the existence of logic bombs, etc.

**QUESTION: 206**

Which of the following operating procedures increases an organization's exposure to computer viruses?

- A. Encryption of data files.
- B. Frequent backup of files.
- C. Downloading public-domain software from websites.
- D. Installing original copies of purchased software on hard disk drives.

**Answer: C**

Viruses are spread through shared data. Downloading public-domain software carries the risk that contaminated data may enter the computer.

**QUESTION: 207**

An organization installed antivirus software on all its personal computers. The software was designed to prevent initial infections, stop replication attempts, detect infections after their occurrence, mark affected system components, and remove viruses from infected components. The major risk in relying on antivirus software is that antivirus software may

- A. Not detect certain viruses.
- B. Make software installation overly complex.
- C. Interfere with system operations
- D. Consume too many system resources.

**Answer: A**

Antivirus software designed to identify and remove known viruses is sometimes known as a vaccine. A vaccine works only for known viruses and may not be effective for variants of those viruses or new viruses.

**QUESTION: 208**

What is the best course of action to take if a program takes longer than usual to load or execute?

- A. Test the system by running a different application program.
- B. Reboot the system.
- C. Run antivirus software.
- D. Back up the hard disk files to floppies.

**Answer: C**

The described condition is a symptom of a virus. Many viruses will spread and cause additional damage. Use of an appropriate antivirus program may identify and even eliminate a viral infection. Ways to minimize computer virus risk in a networked system include restricted access, regularly updated passwords, periodic testing of systems with virus detection software, and the use of antivirus software on all shareware prior to introducing it into the network.

**QUESTION: 209**

Six months after a disgruntled systems programmer was fired and passwords disabled, the company's mainframe computer was brought to a halt when it suddenly erased all of its own files and software. The most likely way the programmer accomplished this was by

- A. Returning to the computer center after 6 months.
- B. Planting a computer virus through the use of telephone access.
- C. Having an accomplice in the computer center.
- D. Implanting a virus in the operating system and executing it via a back door.

**Answer: D**

Viruses are a form of computer sabotage. They are programs hidden within other programs that have the capacity to duplicate themselves and infect other systems. Sharing of storage media or participation in computer networks creates exposure to viruses. Viruses may result in actions ranging from harmless pranks to erasure of files and programs. A back door is a shortcut created in an operating system that permits a programmer simple access to the system.

**QUESTION: 210**

Because of competitive pressures to be more responsive to their customers, some organizations have connected their internal personal computer networks through a host computer to outside networks. A risk of this practice is that

- A. Viruses may gain entry to one or more company systems.
- B. Uploaded files may not be properly edited and validated.
- C. Data downloaded to the personal computers may not be sufficiently timely
- D. Software maintenance on the personal computers may become more costly.

**Answer: A**

Viruses are harmful programs that disrupt memory and processing functions and may destroy data. They spread from network to network, from infected diskettes, or from infected machines. Hence, connecting all networked personal computers through a host computer to outside networks increases the exposure of all of a company's computers to viruses.

**QUESTION: 211**

Attacks on computer networks may take many forms. Which of the following uses the computers of innocent parties infected with Trojan horse programs?

- A. A distributed denial-of-service attack.
- B. A man-in-the-middle attack.
- C. A brute-force attack.
- D. A password-cracking attack.

**Answer: A**

A denial-of-service (DOS) attack is an attempt to overload a system (e.g., a network or Web server) with false messages so that it cannot function (a system crash). A distributed DOS attack comes from multiple sources, for example, the machines of innocent parties infected by Trojan horses. When activated, these programs send messages to the target and leave the connection open. A DOS may establish as many network connections as possible to exclude other users, overload primary memory, or corrupt file systems.

**QUESTION: 212**

Spoofing is one type of online activity used to launch malicious attacks. Spoofing is

- A. Trying large numbers of letter and number combinations to access a network.
- B. Eaves dropping on information sent by a user to the host computer of a website.
- C. Accessing packets flowing through a network.
- D. Identity misrepresentation in cyberspace.

**Answer: D**

Passwords, user account numbers, and other information may be stolen using techniques such as Trojan horses, IP spoofing, and packet sniffers. Spoofing is identity misrepresentation in cyberspace, for example, by using a false website to obtain information about visitors.

**QUESTION: 213**

An organization's computer system should have an intrusion detection system (IDS) if it has external connections. An AIDs.

- A. Must monitor every call on the system as it occurs.
- B. May examine only packets with certain signatures.
- C. Uses only knowledge-based detection.
- D. Uses only behavior-based detection.

**Answer: B**

A network IDS works by using sensors to examine packets traveling on the network. Each sensor monitors only the segment of the network to which it is attached. A packet is examined if it matches a signature. String signatures (certain strings of text) are potential signs of attack. Port signatures alert the IDS that a point subject to frequent intrusion attempts may be under attack. A header signature is a suspicious combination in a packet header.

**QUESTION: 214**

Which of the following is the best program for the protection of a company's vital information resources from computer viruses?

- A. Stringent corporate hiring policies for staff working with computerized functions\_
- B. Existence of a software program for virus prevention.
- C. Prudent management policies and procedures instituted in conjunction with technological safeguards.
- D. Physical protection devices in use for hardware, software, and library facilities.

**Answer: C**

Acceptably safe computing can be achieved by carefully crafted policies and procedures used in conjunction with antivirus and access control software.

**QUESTION: 215**

Which of the following is a malicious program, the purpose of which is to reproduce itself throughout the network and produce a denial of service attack by excessively utilizing system resources?

- A. Logic bomb.
- B. Virus.
- C. Worm.
- D. Trojan horse.

**Answer: C**

A worm is an independent program that reproduces by copying itself from one system to another over a network and consumes computer and network resources.

**QUESTION: 216**

Inefficient use of excess computer equipment can be controlled by

- A. Contingency planning.
- B System feasibility studies.
- C. Capacity planning.
- D Exception reporting\_

**Answer: C**

Planning is as important for the information systems function as for any other part of the organization. The master plan for this function should be consistent with the strategic plan for the organization and include goals and objectives, an inventory of current capacity, and a forecast of future needs. The plan is the basis for determining hardware needs.

**QUESTION: 217**

The best plan for responding to quickly changing information requirements is to foster

- A. Greater online access to information systems.
- B. Competitive pressures for enhanced functions in systems.
- C. Closer linkage between organizational strategy and information.
- D. More widespread use of automated controls.

**Answer: C**

An important management challenge is to integrate the planning, design, and implementation of complex application systems with the strategy of the organization, which will permit the best possible response to quickly changing information requirements.

**QUESTION: 218**

An automobile and personal property insurer has decentralized its information processing to the extent that headquarters has less processing capacity than any of its regional processing centers. These centers are responsible for initiating policies, communicating with policyholders, and adjusting claims. The company uses leased lines from a national telecommunications company. Initially, the company thought there would be little need for interregion communication, but that has not been the case. The company underestimated the number of customers that would move between regions and the number of customers with claims arising from accidents outside their regions. The company has a regional center in an earthquake-prone area and is planning how to continue processing if that center, or any other single center, were unable to perform its processing. The company considered mirroring the data stored at each regional center at another center. A disadvantage of such an arrangement is

- A. Lack of awareness at headquarters of the state of processing.
- B. Increased cost and complexity of network traffic.
- C. Interference of the mirrored data with original source data.
- D. Confusion on the part of insurance agents about where customer data are stored.

**Answer: B**

If data stored at one regional center is to mirror the data stored at another center, the most efficient method to ensure each center has the most current data is to transfer data across a network. Consequently, the cost of network traffic would increase dramatically. The complexity of the network would also increase as the network would need to provide a great deal of security when transferring data.

**QUESTION: 219**

Which of the following statements about desktop computers, servers, and mainframe computers is true?

- A. Desktop computers usually more than servers but less than mainframes.



- B. Because of the increase in use of desktop computers, there will be little need for mainframes in the near future.
- C. Servers must be programmed directly in machine language while mainframes use higher-level language.
- D. The cost per transaction to process on each type of computer has decreased in recent years.

**Answer:** D

Advances in technology have resulted in less expensive computers and increased computing power. The cost to process transactions on all kinds of computers has therefore decreased.

**QUESTION:** 220

An enterprise-wide resource planning (ERP) system integrates the organization's computerized subsystems and may also provide links to external parties. An advantage of ERP is that

- A. The reengineering needed for its implementation should improve business processes.
- B. Customizing the software to suit the unique needs of the organization will facilitate upgrades.
- C. It can be installed by organizations of all sizes.
- D. The comprehensiveness of the system reduces resistance to change.

**Answer:** A

The benefits of ERP may significantly derive from the business process reengineering that is needed for its implementation. Using ERP software that reflects the best practices forces the linked subunits in the organization not only to redesign and improve their processes but also to conform to one standard.

**QUESTION:** 221

A manufacturing resource planning (MRP II) system

- A. Performs the same back-office functions for a manufacturer as an ERP system.
- B. Uses a master production schedule.
- C. Lacks the forecasting and budgeting capabilities typical of an ERP system.
- D. Performs the same front-office functions for a manufacturer as an ERP system.

**Answer:** B

Manufacturing resource planning (MRP II) continued the evolution begun with MRP. It is a closed-loop manufacturing system that integrates all facets of manufacturing, including production, sales, inventories, schedules, and cash flows. The same system is used for accounting and finance functions, which use the same transactions and numbers. MRP II uses an MPS (master production schedule), a statement of the anticipated manufacturing schedule for selected items for selected periods. MRP also uses the MPS. Thus, MRP is a component of an MRP II system.

**QUESTION:** 222

In a traditional ERP system, the receipt of a customer order may result in

- I. Customer tracking of the order's progress
- II. Automatic replenishment of inventory by a supplier
- III. Hiring or reassigning of employees
- IV. Automatic adjustment of output schedules

- A. I, II, and IV only.
- B. I and III only.
- C. III and IV only.
- D. I, II, III, and IV.

**Answer: C**

The traditional ERP system is one in which subsystems share data and coordinate their activities. Thus, if marketing receives an order, it can quickly verify that inventory is sufficient to notify shipping to process the order. Otherwise, production is notified to manufacture more of the product, with a consequent automatic adjustment of output schedules. If materials are inadequate for this purpose, the system will issue a purchase order. If more labor is needed, human resources will be instructed to reassign or hire employees. However, the subsystems in a traditional ERP system are internal to the organization. Hence, they are, often called back-office functions. The information produced is principally but not exclusively) intended for internal use by the organization's managers. The current generation of ERP software (ERP II) has added front-office functions. Consequently, ERP II, but not traditional ERP, is capable of customer tracking of the order's progress and automatic replenishment of inventory by a supplier.

**QUESTION: 223**

What are the possible characteristics of a client-server configuration in a current ERP system?

- I. Thin clients, local area network, single server
- II. Fat clients, wide area network, multiple servers
- III. Fat clients, connection via Internet, and single server

- A. I, II, and III.
- B. II and III only.
- C. II only.
- D. I only.

**Answer: A**

Current ERP systems have a client-server configuration with possibly scores or hundreds of client user) computers. Clients may be thin or fat. So-called thin clients have little processing ability, but fat clients may have substantial processing power. The system may have multiple servers to run applications and contain databases. The network architecture may be in the form of a local area network (LAN) or wide area network (WAN), or users may connect with the server(s) via the Internet. An ERP system may use almost any of the available operating systems and database management systems.

**QUESTION: 224**

A principal advantage of an ERP system is

- A. Program-data dependence.
- B. Data redundancy.
- C. Separate data updating for different functions.
- D. Centralization of data.

**Answer: D**

An advantage of an ERP system is the elimination of data redundancy through the use of a central database. In principle, information about an item of data is stored once, and all

functions have access to it. Thus, when the item such as a price) is updated, the change is effectively made for all functions. The result is reliability data integrity).

**QUESTION: 225**

The current generation of ERP software (ERP II) may include an advanced planning and scheduling system that

- A. Determines the location of retail outlets.
- B. Connects the organization with other members of a joint venture.
- C. Controls the flow of a manufacturer's materials and components through the supply chain.
- D. Permits tracking of orders by customers.

**Answer: C**

An advanced planning and scheduling system may be an element of a supply chain management application for a manufacturer. It controls the flow of materials and components within the chain. Schedules are created given projected costs, lead times, and inventories.

**QUESTION: 226**

The current generation of ERP software (ERP II) has added such front-office functions as

- A. Inventory control.
- B. Human resources.
- C. Purchasing.
- D. Customer service.

**Answer: D**

The current generation of ERP software (ERP II) has added front-office functions. Customer relationship management applications in ERP II extend to customer service, finance-related matters, sales, and database creation and maintenance. Integrated data are helpful in better understanding customer needs, such as product preference or location of retail outlets. Thus, the organization may be able to optimize its sales forecasts, product line, and inventory levels.

**QUESTION: 227**

The company uses a planning system that focuses first on the amount and timing of finished goods demanded and then determines the derived demand for raw materials, components, and subassemblies at each of the prior stages of production. This system is referred to as

- A. Economic order quantity.
- B. Materials requirements planning.
- C. Linear programming.
- D. Just-in-time purchasing.

**Answer: B**

Materials requirements planning (MRP) is a system that translates a production schedule into requirements for each component needed to meet the schedule. It is usually implemented in the form of a computer-based information system designed to plan and control raw materials used in production. It assumes that forecasted demand is reasonably

accurate and that suppliers can deliver based upon this accurate schedule. MRP is a centralized push-through system: output based on forecasted demand is pushed through to the next department or to inventory.

**QUESTION: 228**

Enterprise-wide resource planning (ERP) software packages, such as SAP and Oracle, are all-inclusive systems that attempt to provide entity-wide information. ERP systems provide advantages to the auditor because they

- A. Have proven difficult for some firms to install.
- B. Typically require firms to reduce the division of duties and responsibilities found in traditional systems.
- C. Typically have built-in transaction logs and the ability to produce a variety of diagnostic reports.
- D. Have been installed by smaller firms so, to date, few auditors have encountered them.

**Answer: C**

ERP systems have a variety of controls and report generation functions that allow the auditor to abstract and monitor data collected and processed. Some ERP systems have built-in audit functions.

**QUESTION: 229**

Auditors often make use of computer programs that perform routine processing functions, such as sorting and merging. These programs are made available by computer companies and others and are specifically referred to

- A. Compiler programs.
- B. Supervisory programs.
- C. Utility programs.
- D. User programs.

**Answer: C**

Utility programs are provided by manufacturers of equipment to perform routine processing tasks required by both clients and auditors, such as extracting data, sorting, merging, and copying. Utility programs are pretested, are independent of the client's own programming efforts, and furnish useful information without the trouble of writing special programs for the engagement.

**QUESTION: 230**

In general, mainframe or server production programs and data are adequately protected against unauthorized access. Certain utility software may, however, have privileged access to software and data. To compensate for the risk of unauthorized use of privileged software, IT management can

- A. Prevent privileged software from being installed on the mainframe.
- B. Restrict privileged access to test versions of applications.
- C. Limit the use of privileged software.
- D. Keep sensitive programs and data on an isolated machine.

**Answer: C**

Since certain utility software may have privileged access to software and data stored on

the mainframe or server, management must control the use of this utility software are. Management should limit the use of this software to only those individuals with appropriate authority.

**QUESTION: 231**

A control feature designed to negate the use of utility programs to read files that contain all authorized access user codes for the network is

- A. Internally encrypted passwords.
- B. A password hierarchy.
- C. Logon passwords.
- D. A peer-to-peer network.

**Answer: A**

Utility programs can be used to gain access to almost any file. However, gaining access to a file of passwords would be useless if those passwords were encrypted prior to placing them in the file.

**QUESTION: 232**

Effective internal control for application development should provide for which of the following?

- I A project steering committee to initiate and oversee the system
- II A technical systems programmer to evaluate systems software
- III Feasibility studies to evaluate existing systems
- IV The establishment of standards for systems design and programming

- A. I and III only.
- B. I, II, and IV only
- C. I, III, and IV only.
- D. II, III, and IV only

**Answer: C**

Effective systems development requires participation by top management. This can be achieved through a steering committee composed of higher-level representatives of system users. The committee approves or recommends projects and reviews their progress. Studies of the economic, operational, and technical feasibility of new applications necessarily entail evaluations of existing systems. Another necessary control is the establishment of standards for system design and programming. Standards represent user and system requirements determined during systems analysis.

**QUESTION: 233**

A benefit of using computer-aided software engineering (CASE) technology is that it can ensure that

- A. No obsolete data fields occur in files.
- B. Users become committed to new systems.
- C. All programs are optimized for efficiency.
- D. Data integrity rules are applied consistently.

**Answer: D**

CASE is an automated technology (at least in part) for developing and maintaining

software and managing projects. A benefit of using CASE technology is that it can ensure that data integrity rules, including those for validation and access, are applied consistently across all files.

**QUESTION: 234**

CASE (computer-aided software engineering) is the use of the computer to aid in the development of computer-based information systems. Which of the following could not be automatically generated with CASE tools and techniques?

- A. Information requirements determination.
- B. Program logic design.
- C. Computer program code.
- D. Program documentation.

**Answer: A**

CASE applies the computer to software design and development. It maintains on the computer a library of standard program modules and all of the system documentation. e.g., data flow diagrams, data dictionaries, and pseudocode (structured English). It permits development of executable input and output screens; and generates program code in at least skeletal form. Thus, CASE facilitates the creation, organization, and maintenance of documentation and permits some automation of the coding process. However, information requirements must be determined prior to using CASE.

**QUESTION: 235**

Object technology has become important in companies' strategic use of information systems because of its potential to

- A. Permit quicker and more reliable development of systems.
- B. Maintain programs written in procedural languages.
- C. Minimize data integrity violations in hierarchical databases.
- D. Streamline the traditional "waterfall" systems development methodology.

**Answer: A**

An object-oriented approach is intended to produce reusable code. Because code segments can be reused in other programs, the time and cost of writing software should be reduced.

**QUESTION: 236**

User acceptance testing is more important in an object-oriented development process than in a traditional environment because of the implications of the

- A. Absence of traditional design documents.
- B. Lack of a tracking system for changes.
- C. Potential for continuous monitoring.
- D. Inheritance of properties in hierarchies.

**Answer: D**

In object-oriented development, all objects in a class inherit the properties of higher classes in the hierarchy. Thus, changes in one object may affect many other objects, and the extent and effects of errors significantly increase. Testing one object provides no assurance that the objects are properly coordinated. Accordingly, user acceptance testing to verify correct functioning of the whole system becomes more important.

**QUESTION: 237**

A systems development approach used to quickly produce a model of user interfaces, user interactions with the system, and process logic is called

- A. Neural networking.
- B. Prototyping.
- C. Reengineering.
- D. Application generation.

**Answer: B**

Prototyping produces the first model(s) of a new system. This technique usually employs a software tool for quick development of a model of the user interface such as by report or screen), interaction of users with the system for example, a menu-screen approach or data entry), and processing logic the executable module). Prototyping stimulates user participation because the model allows quick exploration of concepts and development of solutions with quick results.

**QUESTION: 238**

An IT manager has only enough resources to install either a new payroll system or a new data security system, but not both. Which of the following actions is most appropriate?

- A. Giving priority to the security system.
- B. Leaving the decision to the IT manager.
- C. Increasing IT staff output in order for both systems to be installed.
- D. Having the information systems steering committee set the priority.

**Answer: D**

The needs assessment and cost-benefit analysis should be conducted by those responsible for making the decision. In this case, the information systems steering committee is the appropriate decision maker.

**QUESTION: 239**

Which of the following is the most appropriate activity for an internal auditor to perform during a review of systems development activity?

- A. Serve on the IT steering committee that determines what new systems are to be developed.
- B. Review the methodology used to monitor and control the system development function.
- C. Recommend specific automated procedures to be incorporated into new systems that will provide reasonable assurance that all data submitted to an application are converted to machine-readable form.
- D. Recommended specific operational procedures that will ensure that all data submitted for processing are converted to machine-readable form.

**Answer: B**

Auditor objectivity is not impaired when s)he recommends standards of control for systems or reviews procedures before implementation. However, drafting procedures for systems and designing, installing, and operating systems are not audit functions. Thus, reviewing the methodology used by an organization is an appropriate activity that enables the internal auditor to determine whether s)he can rely on the systems



development activity to design and implement appropriate automated controls within applications.

**QUESTION: 240**

A major disadvantage of the life cycle approach to system development is that it is not well-suited for projects that are

- A. Structured.
- B. Large.
- C. Complex.
- D. Unstructured.

**Answer: D**

The life cycle approach is best employed when systems are large and highly structured, users understand the tasks to be performed by the information system, and the developers have directly applicable experience in designing similar systems. In the life cycle process, each stage of development is highly structured, and requirements are clearly defined. However, when the task is unstructured, prototyping may be the better approach.

**QUESTION: 241**

An insurance firm that follows the systems development life cycle concept for all major information system projects is preparing to start a feasibility study for a proposed underwriting system. Some of the primary factors the feasibility study should include are

- A. Possible vendors for the system and their reputation for quality.
- B. Exposure to computer viruses and other intrusions.
- C. Methods of implementation, such as parallel or cut-over.
- D. Technology and related costs.

**Answer: D**

The feasibility study should consider the activity to be automated, the needs of the user. The type of equipment required, the cost, and the potential benefit to the specific area and the company in general. Thus, technical feasibility and cost are determined during this stage

**QUESTION: 242**

Compared with prototyping, life cycle methodologies are appropriate for problems involving

- A. High user understanding of tasks and large project size.
- B. Low user understanding of tasks and small project size.
- C. Low user understanding of tasks and uncertainty of requirements.
- D. Uncertainty of requirements and large project size.

**Answer: A**

The life cycle approach is best employed when systems are large and highly structured, users understand the tasks to be performed by the information system, and the developers have directly applicable experience in designing similar systems. In the life cycle process, each stage of development is highly structured, and requirements are clearly defined.

**QUESTION: 243**



To be more responsive to its customers, a bank wants a system that will permit account representatives to consolidate information about all the a-r-punts belonging to individual customers. Bank management is willing to experiment with different approach approaches because the requirements are evolving rapidly. The best development approach for this system is

- A. Prototyping.
- B. System development life cycle model.
- C. Structured analysis and design technique.
- D. Hierarchy-input-process-output

**Answer:** A

Prototyping is an approach that involves creating a working model of the system requested, demonstrating it for the user, obtaining feedback. and making changes to the underlying code. This process repeats through several iterations until the user is satisfied with the system's functionality. Formerly, this approach was derided as being wasteful of resources and tending to produce unstable systems, but with vastly increased processing power and high-productivity development tools. prototyping can, in some cases, be an efficient means of systems development.

**QUESTION:** 244

A bank was considering its first use of computer-aided software engineering (CASE) to develop an inquiry system for account representatives to access consolidated profiles of customers' accounts. A benefit of using CASE in this situation is that

- A. No new software development tools would be needed.
- B. No training of programmers would be required.
- C. Management of the development process would be improved.
- D. The need for testing would be reduced.

**Answer:** C

CASE applies computers to software design and development. It permits creation and maintenance of systems documentation on the computer and the automation of a part of the programming effort. Using CASE would improve management of the development process because the CASE software maintains the links between the different components, provides built-in project management tools, and supplies automated testing aids.

**QUESTION:** 245

Advantages of life cycle methodologies are

- A. Lower overall development costs when requirements change frequently.
- B. Ability to give users a functioning system quickly.
- C. Reduced application development time to achieve a functioning system.
- D. Enhanced management and control of the development process.

**Answer:** D

The systems development life cycle approach is the most common methodology applied to the development of large, highly structured application systems. The life cycle approach is based on the idea that an information system has a finite life span that is limited by the changing needs of the organization. This cycle is analytically divisible into stages. A new system life cycle begins when the inadequacy of the current system leads to a decision to develop a new or improved system. This method is a structured process for controlling the

creative activity required to devise, develop, and implement an information system. The process is described in varying terms by different writers, but the nature and sequence of the steps are essentially the same. Life cycle methodologies provide enhanced management and control of the development process because they provide structure for a creative process by dividing it into manageable steps and specifying what must be produced in each phase.

**QUESTION: 246**

Program documentation is a control designed primarily to ensure that

- A. Programmers have access to production programs.
- B. Programs do not make mathematical errors.
- C. Programs are kept up to date and perform as intended.
- D. No one has made use of the computer hardware for personal reasons.

**Answer: C**

Complete, up-to-date documentation of all programs and associated operating procedures is necessary for efficient operation of a computer installation. Maintenance of programs is important to provide for continuity and consistency of data processing services to users. Program documentation (the program run manual) consists of problem statements, systems flowcharts, operating instructions, record layouts, program flowcharts, program listings, test data, and approval and change sheets.

**QUESTION: 247**

Rejection of unauthorized modifications to application systems could be accomplished through the use of

- A. Programmed checks.
- B. Batch controls.
- C. Implementation controls.
- D. One-for-one checking.

**Answer: C**

General controls include organizational controls, such as a policy (an implementation control) that requires new programs and changes in programs (after adequate testing) to be formally approved before being put into operation (implemented). This policy is reflected in the maintenance of approval and change sheets with appropriate authorizations.

**QUESTION: 248**

Systems development audit engagements include reviews at various points to ensure that development is properly controlled and managed. The reviews should include all of the following except:

- A. Conducting a technical feasibility study on the available hardware, software, and technical resources
- B. Examining the level of user involvement at each stage of implementation.
- C. Verifying the use of controls and quality assurance techniques for program development, conversion, and testing.
- D. Determining if system, user, and operations documentation conforms to formal standards.

**Answer: A**

The technical feasibility study is conducted by IT professionals, not internal auditors.

**QUESTION: 249**

A hospital is evaluating the purchase of software to integrate a new cost accounting system with its existing financial accounting system. Which of the following describes the most effective way for the internal audit activity to be involved in the procurement process?

- A. The internal audit activity evaluates whether performance specifications are consistent with the hospital's needs.
- B. The internal audit activity evaluates whether the application design meets internal development and documentation standards.
- C. The internal audit activity determines whether the prototyped model is validated and reviewed with users before production use begins.
- D. The internal audit activity has no involvement since the system has already been developed externally.

**Answer: A**

The internal audit activity should be involved to ensure the existence of performance specifications consistent with the hospital's needs. Incomplete or erroneous specifications may result in the acquisition of unusable software or an unenforceable contract with the software vendor.

**QUESTION: 250**

Which of the following controls most likely could prevent computer personnel from modifying programs to bypass programmed controls?

- A. Periodic management review of computer utilization reports and systems documentation.
- B. Segregation of duties within computer for computer programming and computer operations.
- C. Participation of user department personnel in designing and approving new systems.
- D. Physical security of computer facilities in limiting access to computer equipment.

**Answer: B**

Programmers and analysts can modify programs, data files, and controls. Thus, they II should have no access to programs used to process transactions. Segregation of programming and operations is a control necessary to prevent unauthorized modifications of programs.

**QUESTION: 251**

Both users and management approve the initial proposal, design specifications, conversion plan, and testing plan of an information system. This is an example of

- A. Implementation controls.
- B. Hardware controls.
- C. Computer operations controls.
- D. Data security controls.

**Answer: A**

Implementation controls occur in the systems development process at various points to ensure that implementation is properly controlled and managed.

**QUESTION: 252**

An electronics company has decided to implement a new system through the use of rapid application development techniques\_ Which of the following would be included in the development of the new system?

- A. Deferring the need for system documentation until the final modules are completed.
- B. Removing project management responsibilities from the development teams.
- C. Creating the system module by module until completed.
- D. Using object development techniques to minimize the use of previous code.

**Answer: C**

The new system would be developed module by module until completed\_

**QUESTION: 253**

A bank is developing a computer system to help evaluate loan applications. The information systems IS) staff interview the bank's mortgage underwriters to extract their knowledge and decision processes for input into the computer system. The completed system should be able to process information the same as do the underwriters and make final recommendations regarding loan decisions. This approach is called

- A. An expert system.
- B. A neural network.
- C. An intelligent agent.
- D. Fuzzy logic.

**Answer: A**

An expert system is a knowledge-intensive computer program that captures the expertise of a human in limited domains of knowledge.

**QUESTION: 254**

After using the report writer for several months, the marketing analysts gained confidence in using it. but the marketing department manager became concerned. Whenever analysts revised reports they had written earlier, the coding errors kept reappearing in their command sequences. The manager was sure that all the analysts knew what the errors were and how to avoid them. The most likely cause of the reappearance of the same coding errors is inadequate

- A. Backups.
- B. Change control
- C. Access control.
- D. Testing.

**Answer: B**

Change control manages changes in information system resources and procedures. It includes a formal change request procedure; assessments of change requests on technical and business grounds; scheduling changes; testing, installing, and monitoring changes; and reporting the status of recorded changes. The analysts were reusing erroneous code that should have been but was not corrected.

**QUESTION: 255**

The process of monitoring, evaluating, and modifying a system as needed is referred to as systems

- A. Analysis.
- B. Feasibility study.
- C. Maintenance.
- D. Implementation.

**Answer: C**

Systems maintenance must be undertaken by systems analysts and applications programmers continually throughout the life of a system. Maintenance is the redesign of the system and programs to meet new needs or to correct design flaws. These changes should be part of a regular program of preventive maintenance.

**QUESTION: 256**

Change control typically includes procedures for separate libraries for production programs and for test versions of programs. The reason for this practice is to

- A. Promote efficiency of system development
- B. Segregate incompatible duties.
- C. Facilitate user input on proposed changes.
- D. Permit unrestricted access to programs.

**Answer: B**

Separating production and test versions of programs facilitates restricting access to production programs to the individuals, such as computer operators, who need access. The effect is to separate the incompatible functions of operators and programmers.

**QUESTION: 257**

A company often revises its production processes. The changes may entail revisions to processing programs. Ensuring that changes have a minimal impact on processing and result in minimal risk to the system is a function of

- A. Security administration.
- B. Change control.
- C. Problem tracking.
- D. Problem-escalation procedures.

**Answer: B**

Change control is the process of authorizing, developing, testing, and installing coded changes so as to minimize the impact on processing and the risk to the system.

**QUESTION: 258**

Minimizing the likelihood of unauthorized editing of production programs, job control language, and operating system software can best be accomplished by

- A. Database access reviews
- B. Compliance reviews.
- C. Change control procedures.
- D. Network security audits.

**Answer:** C

Program change control includes 1) maintaining records of change authorizations, code changes, and test results, 2) adhering to a systems development methodology including documentation); 3) authorizing changeovers of subsidiary and headquarters' interfaces; and 4) restricting access to authorized source and executable codes.

**QUESTION:** 259

A control for ensuring that the source code and the executable code for a program match is

- A. Verifying that the program move request is authorized.
- B. Requiring program, system, and parallel testing of the code.
- C. Authorizing programmer access to test libraries only.
- D. Recompiling source code into the production load library.

**Answer:** D

Recompiling source code into the production load library ensures that the source and executable codes match because the executable code is created from the source code.

**QUESTION:** 260

Which of the following access setups is appropriate in a computer environment?

	Update Access for Production Data		Update Access for Production Programs	
	Users Have?	Application Programmers Have?	Users Have?	Application Programmers Have?
A.	Yes	No	No	No
B.	Yes	No	No	Yes
C.	No	Yes	Yes	No
D.	No	Yes	Yes	Yes

- A. Yes No No No
- B. Yes No No Yes
- C. No Yes Yes No
- D. No Yes Yes Yes

**Answer:** A

The appropriate setup for access in the computer environment is for users to have update access for production data. Users need to update data through applications programs, but have have no need to change production programs.

**QUESTION:** 261

Most large-scale computer systems maintain at least three program libraries: production library for running programs); source code library maintains original source coding); and test library for programs which are being changed). Which of the following statements is correct regarding the implementation of sound controls over computer program libraries?

- A. Only programmers should have access to the production library.
- B. Users should have access to the test library to determine whether all changes are properly made.

- C. Only the program librarian should be allowed to make changes to the production library.
- D. The computer operator should have access to both the production library and the source code library to assist in diagnosing computer crashes.

**Answer: C**

The program librarian is accountable for, and has custody of, the programs in the production library.

**QUESTION: 262**

Preventing someone with sufficient technical skill from circumventing security procedures and making changes to production programs is best accomplished by

- A. Reviewing reports of jobs completed.
- B. Comparing production programs with independently controlled copies.
- C. Running test data periodically.
- D. Providing suitable segregation of duties.

**Answer: D**

When duties are separated, users cannot obtain a detailed knowledge of programs and computer operators cannot gain unsupervised access to production programs.

**QUESTION: 263**

The marketing department's proposal was finally accepted, and the marketing employees attended a class in using the report writer. Soon, the marketing analysts found that it was easier to download the data and manipulate it on their own desktop computers in spreadsheets than to perform all the data manipulation on the server. One analyst became highly skilled at downloading and wrote downloading command sequences for the other employees. When the analyst left the company for a better job, the department had problems making modifications to these command sequences. The department's problems are most likely due to inadequate

- A. Documentation.
- B. Data backup.
- C. Program testing.
- D. Anti-virus software.

**Answer: A**

One risk of end-user computing is that documentation may be poor and that important knowledge may be limited to one person. The command sequences should have been documented so that other analysts could use and modify them readily.

**QUESTION: 264**

Traditional information systems development procedures that ensure proper consideration of controls may not be followed by users developing end-user computing (EUC) applications. Which of the following is a prevalent risk in the development of EUC applications?

- A. Management decision making may be impaired due to diminished responsiveness to management's requests for computerized information.
- B. Management may be less capable of reacting quickly to competitive pressures



due to increased application development time.

C. Management may place the same degree of reliance on reports produced by EUC applications as it does on reports produced under traditional systems development procedures.

D. Management may incur increased application development and maintenance costs for EUC systems, compared with traditional mainframe) systems.

**Answer: C**

End-user developed applications may not be subject to an independent outside review by systems analysts and are not created in the context of a formal development methodology. These applications may lack appropriate standards, controls, quality assurance procedures, and documentation. A risk of end-user applications is that management may rely on them as much as traditional applications.

**QUESTION: 265**

Traditional information systems development and operational procedures typically involve four functional areas. The systems analysis function focuses on identifying and designing systems to satisfy organizational requirements. The programming function is responsible for the design, coding, testing, and debugging of computer programs necessary to implement the systems designed by the analysis function. The computer operations function is responsible for data preparation, program/job execution, and system maintenance. The user function provides the input and receives the output of the system. Which of these four functions is often poorly implemented or improperly omitted in the development of a new end-user computing (EUC) application?

- A. Systems analysis function.
- B. Programming function.
- C. Computer operations function.
- D. User function.

**Answer: A**

Systems analysis is one step that is not absolutely required in the development of a system. The desire to produce a system quickly may result in this step being eliminated or poorly implemented. A system is often produced and then analyzed to see if it will satisfy the needs of the organization. In an EUC application, the systems analysis is often incomplete or omitted.

**QUESTION: 266**

Responsibility for the control of end-user computing (EUC) exists at the organizational, departmental, and individual user level. Which of the following should be a direct responsibility of the individual users?

- A. Acquisition of hardware and software.
- B. Taking equipment inventories.
- C. Strategic planning of end-user computing.
- D. Physical security of equipment.

**Answer: D**

EUC involves user-created or user-acquired systems that are maintained and operated outside of traditional information systems controls. In this environment, an individual user is ordinarily responsible for the physical security of the equipment s)he uses.

**QUESTION: 267**



Which of the following risks is more likely to be encountered in an end-user computing EUC) environment as compared with a centralized environment?

- A. Inability to afford adequate uninterruptible power supply systems.
- B. User input screens without a graphical user interface GUI).
- C. Applications that are difficult to integrate with other information systems.
- D. Lack of adequate utility programs.

**Answer: C**

The risk of allowing end users to develop their own applications is decentralization of control. End-user developed applications may not be subject to an independent outside review by systems analysts and are not created in the context of a formal development methodology. These applications may lack appropriate standards, controls, and quality assurance procedures. Moreover, when end users create their own applications and files, private information systems may proliferate in which data are largely uncontrolled. These systems may contain the same information, but end-user applications may update and define the data in different ways. Thus, determining the location of data and ensuring data consistency become more difficult because the applications are difficult to integrate.

**QUESTION: 268**

The accountant who prepared a spreadsheet model for workload forecasting left the company, and the accountant's successor was unable to understand how to use the spreadsheet. The best control for preventing such situations from occurring is to ensure that

- A. Use of end-user computing resources is monitored.
- B. End-user computing efforts are consistent with strategic plans.
- C. Documentation standards exist and are followed.
- D. Adequate backups are made for spreadsheet models.

**Answer: C**

The accountant's successor could not use the forecasting model because of inadequate documentation. By requiring that documentation standards exist and are followed, the company will enable new employees to understand internally developed programs when the developer leaves the organization.

**Section 3: Sec Three (269 to 331)**

**Details: Information Technology I**

**QUESTION: 269**

An electronic meeting conducted between several parties at remote sites is referred to as

- A. Teleprocessing.
- B. Interactive processing.
- C. Telecommunicating
- D. Teleconferencing

**Answer: D**

Conducting an electronic meeting among several parties at remote sites is teleconferencing. It can be accomplished by telephone or electronic mail group communication software. Videoconferencing permits the conferees to see each other on

video screens. The practice has grown in recent years as companies have attempted to cut their travel costs.

**QUESTION: 270**

Which of the following statements about voice communications is true?

- A. Modern voice recognition input have large vocabularies and short training periods.
- B. A voice output device converts speech into digital data.
- C. Cell phones and PCS services use the same frequency radio waves.
- D. Pagers can alert users to the receipt of messages but cannot transmit text.

**Answer: A**

Voice recognition input devices provide an alternative to keyboard input. These systems compare the speaker's voice patterns with prerecorded patterns. Advanced systems now have large 'vocabularies and shorter training periods. They allow for dictation and are not limited to simple commands.

**QUESTION: 271**

Contingency plans for information systems should include appropriate backup agreements. Which of the following arrangements would be considered too vendor-dependent when vital operations require almost immediate availability of computer resources?

- A. A "hot site" arrangement.
- B. A "cold site" arrangement.
- C. A "cold and hot site" combination arrangement.
- D. Using excess capacity at another data center within the organization.

**Answer: B**

Organizations should maintain contingency plans for operations in the case of a disaster. These plans usually include off-site storage of important backup data and an arrangement for the continuation of operations at another location. A "cold site" has all needed assets in place except the needed computer equipment and is vendor-dependent for timely delivery of equipment.

**QUESTION: 272**

Each day, after all processing is finished, a bank performs a backup of its online deposit files and retains it for 7 days. Copies of each day's transaction files are not retained. This approach is

- A. Valid, in that having a week's worth of backups permits recovery even if one backup is unreadable.
- B Risky, in that restoring from the most recent backup file would omit subsequent transactions.
- C Valid, in that it minimizes the complexity of backup/recovery procedures if the online file has to be restored.
- D. Risky, in that no checkpoint restart information is kept with the backup files.

**Answer: B**

At appropriate intervals, the disk files should be copied on magnetic tape so that restart procedures can begin at those points if data are lost or destroyed. However, not retaining

each day's transaction files is risky because information processed since the last backup file was created will be lost.

**QUESTION: 273**

A company updates its accounts receivable master file weekly and retains the master files and corresponding update transactions for the most recent 2-week period. The purpose of this practice is to

- A. Verify run-to-run control totals for receivables.
- B. Match internal labels to avoid writing on the wrong volume.
- C. Permit reconstruction of the master file if needed.
- D. Validate groups of update transactions for each version.

**Answer: C**

The grandfather-father-son approach normally employs magnetic tapes to furnish backup in a batch processing system. The procedure involves creation and retention of three generations of master files so that lost or destroyed data may be regenerated from the remaining master files and transaction data. In this case, a master file (the grandfather) and the first week's transactions are used to generate a second master file (the father). This file and the second week's transactions are the basis for the current master file (the son). Online systems employ rollback and recovery procedures. i.e., the master file is periodically dumped onto a storage medium. Reconstruction is then possible using the backup copy and the transactions log.

**QUESTION: 274**

Good planning will help an organization restore computer operations after a processing outage. Good recovery planning should ensure that

- A. Backup/restart procedures have been built into job streams and programs.
- B. Change control procedures cannot be bypassed by operating personnel.
- C. Planned changes in equipment capacities are compatible with projected workloads.
- D. Service level agreements with owners of applications are documented.

**Answer: A**

The disaster plan should embrace data center recovery, critical application recovery, and network recovery. It should be updated and current with regard to recent test results and new applications, equipment, and network configurations. The plan should also ensure that backup facilities are still able to process critical applications and that end-user responsibility is established. Another essential component of a disaster recovery plan is that backup/restart procedures have been anticipated and provided for in the application systems.

**QUESTION: 275**

In an online, real-time system, which of the following is most likely to be used as backup for an application's master file maintained on magnetic disk?

- A. At specified periods, the disk files are dumped to copied on) magnetic tape. a transaction log is maintained as inputs are received and processed.
- B. A duplicate disk file is maintained and all activity is copied on magnetic tape continuously.
- C. The grandfather-father-son technique is employed to retain disk files.
- D. All source documents for transactions are retained.

**Answer: A**

When an application's master file is maintained on magnetic disk in an online, real-time system, the backup procedure most likely to be used is the rollback and recovery method. This method involves the dumping of the master file's contents and associated data structures onto a backup file. In the event of a loss of data, the dump is used together with the transaction log or file to reconstruct the master file.

**QUESTION: 276**

A checkpoint restart procedure is primarily designed to recover from

- A. Programming errors.
- B. Data input errors.
- C. Computer operator errors.
- D. Hardware failures.

**Answer: D**

Checkpoint/restart procedures involve capturing all the values of data and program indicators at specified points and storing these values in another file. If processing is interrupted, it can be resumed at the last checkpoint rather than at the beginning of the run.

**QUESTION: 277**

Which of the following procedures would an entity most likely include in its disaster recovery plan?

- A. Convert all data from EDI format to an internal company format.
- B. Maintain a Trojan horse program to prevent illicit activity.
- C. Develop an auxiliary power supply to provide uninterrupted electricity.
- D. Store duplicate copies of files in a location away from the computer center.

**Answer: D**

Off-site storage of duplicate copies of critical files protects them from a fire or other disaster at the computing facility. The procedure is part of an overall disaster recovery plan. An automobile and personal property insurer has decentralized its information processing to the extent that headquarters has less processing capacity than any of its regional processing centers. These centers are responsible for initiating policies, communicating with policyholders, and adjusting claims. The company uses leased lines from a national telecommunications company. Initially, the company thought there would be little need for interregion communication, but that has not been the case. The company underestimated the number of customers that would move between regions and the number of customers with claims arising from accidents outside their regions. The company has a regional center in an earthquake-prone area and is planning how to continue processing if that center, or any other single center, were unable to perform its processing.

**QUESTION: 278**

The company has considered several alternatives for replacing the hardware required for a regional center's processing. An advantage of using a third-party cold site is that

- A. Personnel employed at the site would be familiar with company operations.

- B. Travel expenses would be minimized for company personnel.
- C. No additional equipment would be required at the regional centers.
- D. The replacement site could be up and running in a few hours.

**Answer: C**

A cold site backup facility is a shell facility where the user can quickly install computer equipment and resume operations in the event of a disaster. The facility has all of the needed assets in place except the needed computer equipment and is vendor-dependent for timely delivery of equipment. Accordingly, an advantage of using a third-party cold site is the elimination of the need for additional equipment. An automobile and personal property insurer has decentralized its information processing to the extent that headquarters has less processing capacity than any of its regional processing centers. These centers are responsible for initiating policies, communicating with policyholders, and adjusting claims. The company uses leased lines from a national telecommunications company. Initially, the company thought there would be little need for interregion communication, but that has not been the case. The company underestimated the number of customers that would move between regions and the number of customers with claims arising from accidents outside their regions. The company has a regional center in an earthquake-prone area and is planning how to continue processing if that center, or any other single center, were unable to perform its processing.

**QUESTION: 279**

Unfortunately, the company has not revised its contingency plan since the time when its data processing was mostly centralized at headquarters. The existing plan is likely to be out of date because of

- A. Changes in equipment, data, and software.
- B. Inadequate processing capability at headquarters.
- C. Lack of arrangements for a backup site for headquarters.
- D. Personnel turnover at regional centers.

**Answer: A**

When a company decentralizes its information processing, many changes in equipment, data, and software occur as a result of the different processing methods. Since the company has not revised its contingency plan since the time processing was centralized, the plan is most likely out of date as a result of the changes in equipment, data, and software.

**QUESTION: 280**

A client is concerned that a power outage or disaster could impair the computer hardware's ability to function as designed. The client desires off-site backup hardware facilities that are fully configured and ready to operate within several hours. The client most likely should consider a

- A. Cold site.
- B. Cool site.
- C. Warm site.
- D. Hot site.

**Answer: D**

A hot site is a service bureau that is a fully operational processing facility and is promptly available in the case of a power outage or disaster.

**QUESTION: 281**

If a corporation's disaster recovery plan requires fast recovery with little or no downtime, which of the following backup sites should it choose?

- A. Hot site.
- B. Warm site.
- C. Cold site.
- D. Quick site.

**Answer: A**

A company uses a hot site backup when fast recovery is critical. The hot site includes all software, hardware, and other equipment necessary for a company to carry out operations. Hot sites are expensive to maintain and may be shared with other organizations with similar needs.

**QUESTION: 282**

The system requiring the most extensive backup and recovery procedures is a(n)

- A. Batch system for payroll processing.
- B. Database system for online order entry.
- C. File-oriented system for billing clients.
- D. Indexed sequential access method file system for fixed asset accounting.

**Answer: B**

Database systems require a more elaborate backup procedure than other systems. A database system for online entry would require almost continuous backup if data loss is to be minimized as transactions are processed on a continuous basis, and without tangible source documentation. Backup procedures that could be employed for online order entry include dual logging and rollback and recovery.

**QUESTION: 283**

The best evidence that contingency planning is effective is to have

- A. No processing interruptions during the past year.
- B. Comprehensive documentation of the plan.
- C. Signoff on the plan by the internal audit activity.
- D. Successful testing of the plan.

**Answer: D**

The only way to know whether contingency planning has been effective is to test the plan, by simulating an interruption or by conducting a paper test with a walk-through of recovery procedures, alternative communication systems and site facilities, information systems backup disaster recovery, business impact assessments and resumption plans, procedures for restoring utility services, and maintenance procedures for ensuring the readiness of the organization in the event of emergency of disaster.

**QUESTION: 284**

The best evidence that contingency planning is effective is to have

- A. No processing interruptions during the past year.
- B. Comprehensive documentation of the plan.
- C. Signoff on the plan by the internal audit activity.
- D. Successful testing of the plan.

**Answer:** D

**QUESTION:** 285

A total interruption of processing throughout a distributed information technology system can be minimized through the use of

- A. Exception reporting.
- B. Fault tolerant
- C. Backup and recovery.
- D. Data file security.

**Answer:** B

An advantage of distributed processing is fault tolerant, that is, the ability to continue processing at all sites es opt a nonfunctioning one.

**QUESTION:** 286

Which of the following would not be appropriate to consider in the physical design of a data center?

- A. Evaluation of potential risks from railroad lines and highways.
- B. Use of biometric access systems.
- C. Design of authorization tables for operating system access.
- D. Inclusion of an uninterruptible power supply system and surge protection.

**Answer:** C

Authorization tables for operating system access address logical controls, not physical controls.

**QUESTION:** 287

Application control objectives do not normally include assurance that

- A. Authorized transactions are completely processed once and only once.
- B. Transaction data are complete and accurate.
- C. Review and approval procedures for new systems are set by policy and adhered to.
- D. Processing results are received by the intended user.

**Answer:** C

Application controls provide reasonable assurance that the recording, processing, and reporting of data are properly performed. Review and approval procedures for new systems are among the general controls known as system sotMrare acquisition and maintenance controls.

**QUESTION:** 288

Authentication is the process by which the

- A. System verifies that the user is entitled to enter the transaction requested.



- B. System verifies the identity of the user.
- C. User identifies him/herself to the system.
- D. User indicates to the system that the transaction was processed correctly.

**Answer:** B

Identification is the process of uniquely distinguishing one user from all others. Authentication is the process of determining that individuals are who they say they are. For example, a password may identify but not authenticate its user if it is known by more than one individual.

**QUESTION:** 289

Which of the following issues would be of most concern to an auditor relating to an organization's Internet security policy?

- A. Auditor documentation.
- B. System efficiency.
- C. Data integrity.
- D. Rejected and suspense item controls.

**Answer:** C

Controls are intended to ensure the integrity, confidentiality, and availability of information. An auditor relies on the integrity of the system's data and programs in making critical decisions throughout the audit process.

**QUESTION:** 290

Passwords for personal computer software programs are designed to prevent

- A. Inaccurate processing of data.
- B. Unauthorized access to the computer.
- C. Incomplete updating of data files.
- D. Unauthorized use of the software.

**Answer:** D

The use of passwords is an effective control in an online system to prevent unauthorized access to computer files. Lists of authorized users are maintained in the computer. The entry of passwords or ID numbers; a prearranged act of personal questions; and use of badges, magnetic cards, or optically scanned cards may be combined to avoid unauthorized access.

**QUESTION:** 291

As organizations become more computer integrated, management is becoming increasingly concerned with the quality of access controls to the computer system. Which of the following provides the most accountability?



	<u>Option I</u>	<u>Option II</u>	<u>Option III</u>	<u>Option IV</u>
Restrict access by:	Individuals	Groups	Individuals	Departments
Identify computer data at:	Field level	Workstation	Workstation	Individual record level
Restrict access:	Need to know	Right to know	Normal processing by employee type	Items identified as processed by department
Identify users by:	Password	Password	Key access to workstation, or password on workstation	Departmental password
Limit ability to:	Delete, add, or modify data	Add or delete files	Add, delete, or modify data stored at workstation	Add, delete, or modify data normally processed by department

- A. Option I.
- B. Option II.
- C. Option III.
- D. Option IV.

**Answer:** A

Access should be limited to those whose activities necessitate access to the computer system. Moreover, the degree of access allowed should be consistent with an individual's responsibilities. Restricting access to particular individuals rather than groups or departments clearly establishes specific accountability. Not everyone in a group will need access or the same degree of access. Thus, passwords assigned to individuals should be required for identification of users by the system. Furthermore, data should be restricted at the field level, not the workstation level. It may be possible to limit access to a workstation, but most workstations are connects -d t. larger mainframe or network databases. Thus, the security at the workstation level only would be insufficient.

**QUESTION:** 292

The primary objective of security software is to

- A. Control access to information system resources.
- B. Restrict access to prevent installation of unauthorized utility software.
- C. Detect the presence of viruses.
- D. Monitor the separation of duties within applications.

**Answer:** A

The objective of security software is to control access to information system resources, such as program libraries, data files, and proprietary software. Security software identifies and authenticates users, controls access to information, and records and investigates security related events and data.

**QUESTION:** 293

An auditor has just completed a physical security audit of a data center. Because the center engages in top- secret defense contract work, the auditor has chosen to recommend biometric authentication for workers entering the building. The recommendation might include devices that verify all of the following except

- A. Fingerprints.
- B. Retina patterns.
- C. Speech patterns.

D. Password patterns.

**Answer: D**

Biometric technologies are automated methods of establishing an individual's identity using physiological or behavioral traits. These characteristics include fingerprints, retina patterns, hand geometry, signature dynamics, speech, and keystroke dynamics.

**QUESTION: 294**

An Internet firewall is designed to provide adequate protection against which of the following?

- A. A computer virus.
- B. Unauthenticated logins from outside users.
- C. Insider leaking of confidential information.
- D. A Trojan horse application.

**Answer: B**

A firewall is a combination of hardware and software that separates two networks and prevents passage of specific types of network traffic while maintaining a connection between the networks. Generally, an Internet firewall is designed to protect a system from unauthenticated logins from outside users, although it may provide several other features as well.

**QUESTION: 295**

Which of the following security controls might prevent unauthorized access to sensitive data via an unattended workstation directly connected to a mainframe?

- A. Use of a screen saver.
- B. Use of passwords to identify users.
- C. Encryption of data files.
- D. Automatic log-off of inactive users.

**Answer: D**

Automatic log-off of inactive users is a utility that disconnects a workstation from the mainframe or server after a certain amount of time. Once the workstation has been disconnected, the user must log back into the system.

**QUESTION: 296**

Which of the following is an objective of logical security controls for information systems?

- A. To ensure complete and accurate recording of data.
- B. To ensure complete and accurate processing of data.
- C. To restrict access to specific data and resources.
- D. To provide an audit trail of the results of processing.

**Answer: C**

The primary objective of security controls for information systems is to restrict access to data and resources (both hardware and software) to only authorized individuals.

**QUESTION: 297**

Which of the following is the most effective user account management control in preventing the unauthorized use of a computer system?

- A. Management enforces an aggressive password policy that requires passwords to be 10 characters long, to be nonreusable, and to be changed weekly.
- B. An account manager is responsible for authorizing and issuing new accounts.
- C. The passwords and usernames of failed log-in attempts are logged and documented in order to cite attempted infiltration of the system.
- D. Employees are required to renew their accounts semiannually.

**Answer: D**

Management's network security policy should include measures to ensure that old and unused accounts are removed promptly. If employees' accounts expire semiannually, reasonable assurance is provided that accounts in use by unauthorized employees do not exist.

**QUESTION: 298**

Assigning passwords to computer users is a control to prevent unauthorized access. Because a password does not conclusively identify a specific individual, it must be safeguarded from theft. A method used to protect passwords is to

- A. Require that they be displayed on computer screens but not printed on hard copy output.
- B. Set maximum character lengths.
- C. Require passwords to be changed periodically.
- D. Eliminate all records of old passwords.

**Answer: C**

Security measures include changing passwords frequently, that is, establishing a relatively short maximum retention period; not displaying or printing passwords; setting minimum lengths; prohibiting the use of certain words, character strings, or names, mandating a minimum retention period so users cannot promptly change passwords back to their old and convenient values; and retaining old passwords to prevent their use.

**QUESTION: 299**

The best source of evidence to determine if ex-employees continue to have access to a company's computer systems is

- A. Discussing the password removal process with the information security officer.
- B. Reviewing computer logs of access attempts.
- C. Reconciling current payroll lists with database access lists.
- D. Reviewing access control software to determine whether the most current version is implemented.

**Answer: C**

To determine if ex-employees are accessing the company's computer systems, the auditor should obtain the log showing system access. This log should be compared with current payroll lists to see if anyone not on the payroll is still accessing or is able to access the systems.

**QUESTION: 300**

A client installed the most sophisticated controls using biometric attributes of employees to gain access to their computer system. This technology most likely replaced which of the following controls?

- A. Use of security specialists.
- B. Reasonableness tests.
- C. Passwords.
- D. Virus protection software.

**Answer: C**

The purpose of passwords is to prevent access by unauthorized users just as the more sophisticated control of employee biometric attributes. The use of passwords is an effective control in an online system to prevent unauthorized access to computer systems. However, biometric technologies are more sophisticated and difficult to compromise.

**QUESTION: 301**

Computer program libraries should be kept secure by

- A. Installing a logging system or program access.
- B. Monitoring physical access to program library media.
- C. Restricting physical and logical access.
- D Denying remote access via terminals.

**Answer: C**

An important operating control is to establish a library to preclude misplacement, misuse, or theft of data files, programs, and documentation. A librarian should perform this custodianship function and be appropriately accountable. Restricting physical and logical access secures programs from unauthorized use, whether in person or remotely via terminals.

**QUESTION: 302**

Data access security related to applications may be enforced through all of the following except

- A. User identification and authentication functions incorporated in the application.
- B. Utility software functions.
- C. User identification and authentication functions in access control software.
- D. Security functions provided by a database management system.

**Answer: B**

Utility programs perform routine functions (e.g., sorting and copying), are available to all users, and are promptly available for many different applications. Utility programs are one of the more serious weaknesses in data access security because some can bypass normal access controls.

**QUESTION: 303**

Which of the following would provide the least security for sensitive data stored on a notebook computer?

- A. Encrypting data files on the notebook computer.
- B. Using password protection for the screen-saver program on the notebook computer.
- C. Using a notebook computer with a removable hard disk drive.
- D. Locking the notebook computer in a case when not in use.

**Answer:** B

Password protection for a screen-saver program can be easily bypassed.

**QUESTION:** 304

Which of the following would be of greatest concern to an auditor reviewing a policy regarding the sale of a company's used personal computers to outside parties?

- A. Whether deleted files on the hard disk drive have been completely erased.
- B. Whether the computer has viruses.
- C. Whether all software on the computer is properly licensed.
- D. Whether there is terminal emulation software on the computer.

**Answer:** A

While most delete programs erase file pointers, they do not remove the underlying data. The company must use special utilities that fully erase the data. This is important because of the potential for confidential data on the microcomputers.

**QUESTION:** 305

Which implemented control would best assist in meeting the control objective that a system have the capability to hold users accountable for functions performed?

- A. Programmed cutoff.
- B. Redundant hardware.
- C. Activity
- D. Transaction error logging.

**Answer:** C

Activity logging provides an audit trail of user activity.

**QUESTION:** 306

Which new issues, associated with rapidly advancing computer technology, create new risk exposures for organizations?

- A. Changes in organizational reporting requirements and controls over computer abuse.
- B. Controls over library tape procedures.
- C. Complexity of operating systems and controls over privacy of data.
- D. Changes in organizational behavior.

**Answer:** C

Advancing computer technology presents more complex audit environments. With the advent of systems that permit remote access, the risk that unauthorized parties may obtain or tamper with important information is increased.

**QUESTION: 307**

Which of the following is an important senior management responsibility with regard to information systems security?

- A. Assessing exposures.
- B. Assigning access privileges.
- C. Identifying ownership of data.
- D. Training employees in security matters.

**Answer: A**

Senior management is responsible for risk assessment, including identification of risks and consideration of their significance, the likelihood of their occurrence, and how they should be managed. Senior management is also responsible for establishing organizational policies regarding computer security and implementing a compliance structure. Thus, senior management should assess the risks to the integrity, confidentiality, and availability of information systems data and resources.

**QUESTION: 308**

Management's enthusiasm for computer security seems to vary with changes in the environment, particularly the occurrence of other computer disasters. Which of the following concepts should be addressed when making a comprehensive recommendation regarding the costs and benefits of computer security?

Potential loss if security is not implemented

Probability of occurrences

Cost and effectiveness of the implementation and operation of computer security

- A. I only.
- B. I and II only.
- C. III only.
- D. I, II, and III.

**Answer: D**

Potential loss is the amount of dollar damages associated with a security problem or loss of assets. Potential loss times the probability of occurrence is an estimate expected value) of the exposure associated with lack of security. It represents a potential benefit associated with the implementation of security measures. To perform a cost-benefit analysis, the costs should be considered. Thus, all three items need to be addressed.

**QUESTION: 309**

Of the following, the greatest advantage of a database server) architecture is

- A. Data redundancy can be reduced.
- B. Conversion to a database system is inexpensive and can be accomplished quickly.
- C. Multiple occurrences of data items are useful for consistency checking.
- D. Backup and recovery procedures are minimized.

**Answer: A**

Data organized in files and used by the organization's various applications programs are collectively known as a database. In a database system, storage structures are created that render the applications programs independent of the physical or logical arrangement of the data. Each data item has a standard definition, name, and format, and related items are linked by a system of pointers. The programs therefore need only to

specify data items by name, not by location. A database management system handles retrieval and storage. Because separate files for different applications programs are unnecessary, data redundancy can be substantially reduced.

**QUESTION: 310**

In an inventory system on a database management system (DBMS), one stored record contains part number, part name, part color, and part weight. These individual items are called

- A. Fields.
- B. Stored files.
- C. Bytes.
- D. Occurrences.

**Answer: A**

A record is a collection of related data items (fields). A field (data item) is a group of characters representing one unit of information.

**QUESTION: 311**

An inventory clerk, using a computer terminal, views the following on screen: part number, part description, quantity on hand, quantity on order, order quantity, and reorder point for a particular inventory item. Collectively, these data make up a

- A. Field.
- B. File.
- C. Database.
- D. Record.

**Answer: D**

A record is a collection of related data items (fields). A field (data item) is a group of characters representing one unit of information. The part number, part description, etc., are represented by fields.

**QUESTION: 312**

Which of the following is the elementary unit of data storage used to represent individual attributes of an entity?

- A. Database.
- B. Data field.
- C. File.
- D. Record.

**Answer: B**

A data item (or field) is a group of characters. It is used to represent individual attributes of an entity, such as an employee's address. A field is an item in a record.

**QUESTION: 313**

A file-oriented approach to data storage requires a primary record key for each file. Which of the following is a primary record key?

- A. The vendor number in an accounts payable master file.
- B. The vendor number in a closed purchase order transaction file.
- C. The vendor number in an open purchase order master file\_
- D. All of the answers are correct.

**Answer: A**

The primary record key uniquely identifies each record in a file. Because there is only one record for each vendor in an accounts payable master file, the vendor number would be the appropriate key.

**QUESTION: 314**

A business is designing its storage for accounts receivable information. What data file concepts should be used to provide the ability to answer customer inquiries as they are received?

- A. Sequential storage and chains.
- B. Sequential storage and indexes.
- C. Record keys, indexes, and pointers.
- D. Inverted file structure indexes, and internal labels.

**Answer: C**

A record key is an attribute that uniquely identifies or distinguishes each record from the others. An index is a table listing storage locations for attributes, often including those other than the unique record key attribute. A pointer is a data item that indicates the physical address of the next logically related record.

**QUESTION: 315**

Auditors making database queries often need to combine several tables to get the information they want. One approach to combining tables is known as

- A. Extraction.
- B. Joining.
- C. Sorting.
- D. Summarization.

**Answer: B**

In data management terminology, joining is the combining of data files based on a common data element. For example, if rows in a table containing information about specified parts have been selected, the result can be joined with a table that contains information about suppliers. The join operation may combine the two tables using the supplier number assuming both tables contained this element) to provide information about the suppliers of particular parts.

**QUESTION: 316**

Users making database queries often need to combine several tables to get the information they want. One approach to combining tables is

- A. Joining.
- B. Merging.
- C. Projecting.



D. Pointing.

**Answer:** A

Joining is the combining of two or more relational tables based on a common data element. For example, if a supplier table contains information about suppliers and a parts table contains information about parts, the two tables can be joined using the supplier number assuming both tables contain this attribute) to give information about the supplier of particular parts.

**QUESTION:** 317

All of the following are methods for distributing a relational database across multiple servers except

- A. Snapshot making a copy of the database for distribution).
- B. Replication creating and maintaining replica copies at multiple locations)\_
- C. Normalization separating the database into logical tables for easier user processing).
- D. Fragmentation separating the database into parts and distributing where they are needed).

**Answer:** C

A distributed database is stored in two or more physical sites. The two basic methods of distributing a database are partitioning and replication\_ However, normalization is a process of database design, not distribution. Normalization is the term for determining how groups of data items in a relational structure are arranged in records in a database. This process relies on "normal forms," that is, conceptual definitions of data records and specified design rules\_ Normalization is intended to prevent inconsistent updating of data items. It is a process of breaking down a complex data structure by creating smaller, more efficient relations, thereby minimizing or eliminating the repeating groups in each relation.

**QUESTION:** 318

In a database system, locking of data helps preserve data integrity by permitting transactions to have control of all the data needed to complete the transactions. However, implementing a locking procedure could lead to

- A. Inconsistent processing.
- B. Rollback failures.
- C. Unrecoverable transactions.
- D. Deadly embraces retrieval contention).

**Answer:** D

In a distributed processing system, the data and resources a transaction may update or use should be held in their current status until the transaction is complete. A deadly embrace occurs when two transactions need the same resource at the same time. If the system does not have a method to cope with the problem efficiently, response time worsens or the system eventually fails. The system should have an algorithm for undoing the effects of one transaction and releasing the resources it controls so that the other transaction can run to completion.

**QUESTION:** 319

One advantage of a database management system (DBMS) is

- A. That each organizational unit takes responsibility and control for its own data.
- B. The cost of the data processing department decreases as users are now responsible for establishing their own data handling techniques.
- C A decreased vulnerability as the database management system has numerous security controls to prevent disasters.
- D The independence of the data from the application programs. which allows the programs to be developed for the user's specific needs without concern for data capture problems.

**Answer: D**

A fundamental characteristic of databases is that applications are independent of the database structure; when writing programs or designing applications to use the database. only the name of the desired item is necessary. Programs can be developed for the user's specific needs without concern for data capture problems. Reference can be made to the items using the data manipulation language, after which the DBMS takes care of locating and retrieving the desired items. The physical or logical structure of the database can be completely altered without having to change any of the programs using the data items, only the schema requires alteration.

**QUESTION: 320**

Which of the following is a false statement about a database management system application environment?

- A. Data are used concurrently by multiple users.
- B. Data are shared by passing files between programs or systems.
- C. The physical structure of the data is independent of user needs.
- D. Data definition is independent of any one program.

**Answer: B**

In this kind of system, applications use the same database There is no need to pass files between applications.

**QUESTION: 321**

Which of the following should not be the responsibility of a database administrator?

- A. Design the content and organization of the database.
- B. Develop applications to access the database.
- C. Protect the database and its software.
- D. Monitor and improve the efficiency of the database.

**Answer: B**

The database administrator (DBA) is the person who has overall responsibility for developing and maintaining the database. One primary responsibility is for designing the content of the database. Another responsibility of the DBA is to protect and control the database. A third responsibility is to monitor and improve the efficiency of the database. The responsibility of developing applications to access the database belongs to systems analysts and programmers.

**QUESTION: 322**

The responsibilities of a data administrator (DA) include monitoring

- A. The database industry.
- B. The performance of the database.
- C. Database security.
- D. Backup of the system.

**Answer:** A

The DA handles administrative issues that arise regarding the database. The DA acts as an advocate by suggesting new applications and standards. One of the DA's responsibilities is to monitor the database industry for new developments. In contrast, the database administrator (DBA) deals with the technical aspects of the database.

**QUESTION:** 323

To trace data through several applications on programs, an auditor needs to know what programs use the data, which files contain the data, and which print-out reports display the data. If data exist only in a database system, the auditor could probably find all of this information in a

- A. Data dictionary.
- B. Database schema.
- C. Data encryptor.
- D. Decision table.

**Answer:** A

The data dictionary is a file (possibly manual but usually computerized) in which the records relate to specified data items. It contains definitions of data items, the list of programs used to process them, and the reports in which data are found. Only certain persons or entities are permitted to retrieve data or to modify data items. Accordingly, these access limitations are also found in the data dictionary.

**QUESTION:** 324

Image processing systems have the potential to reduce the volume of paper circulated throughout an organization. To reduce the likelihood of users relying on the wrong images, management should ensure that appropriate controls exist to maintain the

- A. Legibility of image data.
- B. Accessibility of image data.
- C. Integrity of index data.
- D. Initial sequence of index data.

**Answer:** C

Data integrity is a protectability objective. If index data for image processing systems are corrupted, users will likely be relying on the wrong images.

**QUESTION:** 325

What language interface would a database administrator use to establish the structure of database tables?

- A. Data definition language.
- B. Data control language.
- C. Data manipulation language.

D. Data query language.

**Answer: A**

The schema is a description of the overall logical structure of the database using data-definition language DDL), which is the connection between the logical and physical structure of the database. DDL is used to define, or determine, the database.

**QUESTION: 326**

Query facilities for a database system would most likely include all of the following except

- A. Graphical output capability.
- B. Data dictionary access.
- C. A data validity checker.
- D. A query-by-example interface.

**Answer: C**

The least likely feature of a query tool would be a data validity checker because the database system has already enforced any validity constraints at the time the data were inserted in the database. Any further data validity checking would be a function of a user application program rather than a query.

**QUESTION: 327**

Which of the following would be the most appropriate starting point for a compliance evaluation of software licensing requirements for an organization with more than 15,000 computer workstations?

- A. Determine if software installation is controlled centrally or distributed throughout the organization.
- B. Determine what software packages have been installed on the organization's computers and the number of each package installed.
- C. Determine how many copies of each software package have been purchased by the organization.
- D. Determine what mechanisms have been installed for monitoring software usage.

**Answer: A**

The logical starting point is to determine the point(s) of control. Evidence of license compliance can then be assessed. For example, to shorten the installation time for revised software in a network, an organization may implement electronic software distribution (ESD), which is the computer-to-computer installation of software on workstations. Instead of weeks, software distribution can be accomplished in hours or days and can be controlled centrally. Another advantage of ESD is that it permits tracking or metering of PC program licenses.

**QUESTION: 328**

Use of unlicensed software in an organization

- I. Increases the risk of introducing viruses into the organization
- II. Is not a serious exposure if only low-cost software is involved
- III. Can be detected by software checking routines that run from a network server

- A. I only.
- B. I and II only.

- C. I, II, and III.
- D. I and III only.

**Answer:** D

Antivirus measures should include strict adherence to software acquisition policies. Unlicensed software is less likely to have come from reputable vendors and to have been carefully tested. Special software is available to test software in use to determine whether it has been authorized.

**QUESTION:** 329

The Internet consists of a series of networks that include

- A. Gateways to allow personal computers to connect to mainframe computers.
- B. Bridges to direct messages through the optimum data path\_
- C. Repeaters to physically connect separate local area networks LANs).
- D. Routers to strengthen data signals between distant computers.

**Answer:** A

The Internet facilitates information transfer between computers. Gateways are hardware or software products that allow translation between two different protocol families. For example, a gateway can be used to exchange messages between different email systems.

**QUESTION:** 330

Which of the following is true concerning HTML?

- A. The acronym stands for HyperText Material Listing.
- B. The language is among the most difficult to learn
- C. The language is independent of hardware and software.
- D. HTML is the only language that can be used for Internet documents.

**Answer:** C

HTML is the most popular language for authoring Web pages. It is hardware and software independent, which means that it can be read by several different applications and on many different kinds of computer operating systems. HTML uses tags to mark information for proper display on Web pages.

**QUESTION:** 331

Which of the following is a false statement about XBRL?

- A. XBRL is freely licensed.
- B. XBRL facilitates the automatic exchange of information
- C. XBRL is used primarily in the U.S.
- D. XBRL is designed to work with a variety of software applications.

**Answer:** C

XBRL stands for eXtensible Business Reporting Language. It is being developed for business and accounting applications. It is an XML-based application used to create, exchange, and analyze financial reporting information and is being developed for worldwide use.

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